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NAVAL PETROLEUM RESERVES

ORIGINAL

HEARING

BEFORE THE

SUBCOMMITTEE ON
FOSSIL AND SYNTHETIC FUELS

COMPLETED
172

OF THE

COMMITTEE ON ENERGY AND COMMERCE

AND THE

INVESTIGATIONS SUBCOMMITTEE

OF THE

COMMITTEE ON ARMED SERVICES
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

SECOND SESSION

ON

H.R. 4843 and H.R. 4859

BILLS TO AMEND THE ENERGY POLICY AND CONSERVATION ACT TO IMPROVE POLICY, PRODUCTION, AND PRICING MECHANISMS OF THE NAVAL PETROLEUM RESERVES

JUNE 11, 1986

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CONTENTS

	Page
Text of:	
H.R. 4843	4
H.R. 4859	8
Testimony of:	
Bauer, Donald L., Acting Assistant Secretary for Fossil Energy, Department of Energy	26
Berg-Hansen, Stephen, executive vice president, California Independent Producers Association	81
Cameron, John T., vice president of producing, exploration, and land, Chevron U.S.A., Inc.	74
Duffus, James, III, Associate Director, Resources, Community, and Economic Development Division, General Accounting Office	62
Furiga, Richard D., Deputy Assistant Secretary for Petroleum Reserves, Department of Energy	26
Redd, Bob, vice president, Golden West Refining Co., on behalf of the American Independent Refiners Association	93
Rumbold, William W., Director of Naval Petroleum and Oil Shale Reserves, Department of Energy	26
Thomas, Hon. William M., a Representative in Congress from the State of California	13
Tillman, James, Procurement Operations, Department of Energy	26
Material submitted for the record by:	
Alton Corp.: Letter from Eric S. Bradley, president, June 3, 1986	119
Bentsen, Hon. Lloyd, a U.S. Senator from the State of Texas, statement	19
Champlin Petroleum Co.: Letter and statement from D. W. Niemiec, general manager, June 23, 1986	122
Energy Department: Letter from Secretary John S. Herrington to Chairman Sharp, May 29, 1986	157
Fossil and Synthetic Fuels Subcommittee: Staff memorandum	149
Kern Oil & Refining Co.: Letter from Thomas L. Eveland, vice president, June 19, 1986	134
Newhall Refining Co., Inc.: Letters and white paper from E. J. Barnes, president	137

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NAVAL PETROLEUM RESERVES

WEDNESDAY, JUNE 11, 1986

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON FOSSIL AND SYNTHETIC FUELS, COMMITTEE ON ENERGY AND COMMERCE, AND THE SUBCOMMITTEE ON INVESTIGATIONS, COMMITTEE ON ARMED SERVICES,

Washington, DC.

The subcommittees met, pursuant to notice, at 10:25 a.m., in room 2123, Rayburn House Office Building, Hon. Philip R. Sharp (chairman, Subcommittee on Fossil and Synthetic Fuels) presiding (Hon. Bill Nichols, chairman, Subcommittee on Investigations).

Mr. SHARP. The subcommittees will please come to order.

I welcome the opportunity to join once again with the Investigation Subcommittee of the Armed Services Committee in an area where our concerns about energy policy and their concerns about defense policy intersect.

Today's hearing is to review the recent sale of oil from the Elk Hills Naval Petroleum Reserve and legislation designed to correct problems which that sale demonstrated. Since April, the Government has been selling oil from Elk Hills at prices as low as $6.23 per barrel. In some cases, the result was the sale of Elk Hills oil by the Department of Energy for about half the price of oil purchased by the Department for the Strategic Petroleum Reserve.

These prices resulted from a bidding process that was not responsive to the radical changes in the oil market which occurred earlier this year. Two actions can prevent this low priced sale of a Government asset.

First, the Department should cancel the existing contracts for Elk Hills oil and seek new bids. Secretary Herrington has indicated a commendable willingness to improve the bidding process, but the decision to continue the current contracts while reviewing the process is costing the Government hundreds of thousands of dollars per day in lost revenue.

During July, August, and September, the Government will probably lose $20 million on the sale of 6 million barrels of oil.

Second, the Congress should pass legislation giving DOE more flexibility in setting production rates at Elk Hills, and preventing sales of oil at prices significantly below market.

A broader issue involves the proposal to sell the Government's share of the NPR. The decisions in 1976, 1981, and 1984 to produce the fields at their maximum rate has diminished their value to the Nation as a reserve for energy security purposes, and we should be willing to examine their sale to the private sector. This is not the topic of this morning's hearing, but our willingness to authorize

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the Department to sell the reserves may be affected by how well they protect the taxpayers' interest in the current sale of oil.

I am delighted to welcome our cochairman for this hearing, the Honorable William Nichols, chairman of the Investigation Subcommittee of the Armed Services Committee.

Mr. NICHOLS. Thank you, Mr. Chairman. We appreciate the opportunity to participate with the Fossil and Synthetic Fuels Subcommittee in this hearing to consider the current problems in the administration of Naval Petroleum Reserve No. 1, at Elk Hills, and the two bills, H.R. 4843 and H.R. 4859, designed to address those problems. I note, Mr. Chairman, that both bills have been referred jointly to the Committee on Armed Services and the Committee on Energy and Commerce.

As you and other members of the committee know, the Committee on Armed Services has been closely involved in legislative oversight of the administration of naval petroleum reserves now for more than 60 years. In fact, the rules of the House of Representatives give this committee jurisdiction over the conservation, the development, and the use of the reserves.

I believe it is fair to say that if it were not for the vigilance of our late chairman, Carl Vinson, there would be no naval petroleum reserves to produce today. Their oil would have been depleted years and years ago. His vision preserved the naval petroleum reserves as a national defense asset, and it is still very much, Mr. Chairman, the intention of the Committee on Armed Services to preserve these resources for national defense use.

In view of that history, no one should be surprised that our committee is concerned, both by the recent production rate at Elk Hills, and the sales price of the oil being produced there. We believe that the Naval Petroleum Reserve Production Act requirement that the reserves be produced at the maximum efficient rate of production is unwise. Since the Congress decided that reserves should be produced, it should have been left to some discretion of the Secretary of Energy to determine the proper rate of production, but not in excess of the maximum efficient rate.

In the operation of any large oil field, we believe the management of the naval petroleum reserves should be allowed to take into consideration world oil supplies, the sales price of oil, the condition of the strategic petroleum reserve, and national energy policies.

Notwithstanding the statutory requirement for production at Elk Hills at the maximum efficient rate, I believe that the Secretary of Energy was remiss, Mr. Chairman, in continuing production at 127,000 barrels per day after April 1, 1986. He certainly must have been aware of the giveaway prices when the bids were submitted in February. Assistant Secretary Vaughan told these subcommittees in October 1984, "There is no precise, technically indisputable level for 'maximum efficient rate' of production."

We have observed the dispute that has raged over the proper maximum efficient rate at Elk Hills now for more than 2 years. It seems to me that the Secretary, when he saw the range of the bids, could have reduced production to the lowest proposed maximum efficient rate, thereby at least reducing the amount of bargain-basement oil being produced, but it was not until May 22 that he final-

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ly became convinced of the wisdom of such a move, when he directed that, as of June 1, production would be reduced from 127,000 barrels per day to 106 barrels per day. We commend him on that action, but I have to say we wonder why it took him so long.

I also wish to point out that the Secretary of Defense is not required to sell the production of the naval petroleum reserves. Section 7430, title 10, United States Code, provides that the Secretary, "shall use, store, or sell the petroleum produced." That section further authorizes the President to direct that the U.S. share of production for naval petroleum reserves may be placed in a strategic petroleum reserve, or exchanged for other petroleum to be placed in the strategic petroleum reserve.

In view of that broad authority for storage use of the production, it is incomprehensible to me that the Secretary of Energy felt compelled to sell this oil for as little as $6.30 per barrel. I believe that arrangements could have been made to store the Elk Hills production in the strategic petroleum reserve, or to exchange it for other petroleum to be stored in the strategic petroleum reserve, or to place it in other storage facilities, or to make it available to the Department of Defense to exchange for refined products.

Mr. Chairman, we have examined both bills, H.R. 4843 and H.R. 4859, and we are in agreement with their intent to provide more flexibility in the production rate, and to obtain a better price for oil produced at the reserves. We believe, however, that any amending legislation should be codified in chapter 641, title 10, United States Code, which contains all existing legislation relative to naval petroleum reserves.

We believe that that codification of this legislation and title 42 would isolate these important functions in the operation of reserves from all other legislation governing the operation.

I thank you, Mr. Chairman, for your courtesy.

[The text of H.R. 4843 and H.R. 4859 follows:]

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99TH CONGRESS
2D SESSION

H. R. 4843

To amend the Energy Policy and Conservation Act for the purpose of improving national energy policy.

IN THE HOUSE OF REPRESENTATIVES

MAY 15, 1986

Mr. SHARP (for himself, Mr. BRYANT, Mr. EDGAR, Mr. RALPH M. HALL, Mr. LELAND, Mr. RICHARDSON, Mr. SHELBY, Mr. SYNAR, Mr. TAUZIN, and Mr. WALGREN) introduced the following bill; which was referred jointly to the Committees on Armed Services and Energy and Commerce

---

A BILL

To amend the Energy Policy and Conservation Act for the purpose of improving national energy policy.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. FINDINGS AND PURPOSES.

(a) FINDINGS.—The Congress finds that—

(1) the achievement of energy security for the United States is essential to the national interest, the health of the national economy, and the well-being of the citizens of the United States;

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(2) the efficient management of the petroleum reserves within the jurisdiction of the Department of Energy is vital to the energy security of the United States;

(3) flexible production rates for such petroleum reserves can increase the contribution made by such reserves to energy security, reduce their detrimental impact on domestic stripper well production, and increase their long-term revenue contribution to the Federal Government; and

(4) the sale of petroleum from the naval petroleum reserves at prices below the price of petroleum purchased for the Strategic Petroleum Reserve, taking into consideration quality and location, is a waste of national resources and reflects a flawed national energy policy.

(b) PURPOSES.—The purposes of this Act are—

(1) to grant specific authority to the President to adjust the production rate for the petroleum reserves described in subsection (a)(2), on the basis of energy security considerations, petroleum market price fluctuations, and long-term revenue implications for the Federal Government; and

(2) to prevent the sale of petroleum from the naval petroleum reserves for prices significantly below

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prevailing market prices or below the cost of acquiring petroleum for the Strategic Petroleum Reserve.

SEC. 2. IMPROVING NATIONAL ENERGY POLICY.

Section 164 of the Energy Policy and Conservation Act (42 U.S.C. 6244) (relating to naval petroleum reserves) is amended to read as follows:

"COORDINATION OF NATIONAL ENERGY POLICY CONCERNING PETROLEUM RESERVES

"SEC. 164. For the purpose of improving the coordination of national energy policy with respect to the Strategic Petroleum Reserve and the naval petroleum reserves, the President—

"(1) may, with respect to any production of petroleum from Naval Petroleum Reserves Numbered 1, 2, or 3, establish a production rate that is less than the maximum efficient rate and that is consistent with sound engineering practices and the protection, conservation, maintenance, and testing of such Reserves, if the President determines that such rate is in the interest of national energy policy, taking into consideration the energy security of the United States (including the fill rate of, and quantity of petroleum in, the Strategic Petroleum Reserve), market conditions in the petroleum industry (and the effect of such conditions on the Strategic Petroleum Reserve and Naval Petroleum Reserves Numbered 1, 2, and 3), and the effect of such

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production rate on the maximum amount of revenues which could be realized from Naval Petroleum Reserves Numbered 1, 2, and 3; and

"(2) shall, notwithstanding any other provision of law, establish a minimum price for the sale of the United States' share of petroleum produced from Naval Petroleum Reserves Numbered 1, 2, and 3 at an amount not less than the higher of—

"(A) 90 percent of the current sales price, as estimated by the Secretary of Energy, of comparable petroleum in the same area; or

"(B) the price of petroleum being purchased for the Strategic Petroleum Reserve, minus the cost of transporting petroleum from the naval petroleum reserve concerned to the nearest storage area of the Strategic Petroleum Reserve, with adjustments for the difference in the quality of the petroleum being purchased for the Strategic Petroleum Reserve and petroleum being produced from the naval petroleum reserve concerned.".

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99TH CONGRESS
2D SESSION

H. R. 4859

To enhance the value of the naval petroleum reserves by improving the production and pricing mechanisms applicable to such reserves.

IN THE HOUSE OF REPRESENTATIVES

MAY 20, 1986

Mr. THOMAS of California introduced the following bill; which was referred jointly to the Committees on Armed Services and Energy and Commerce

---

A BILL

To enhance the value of the naval petroleum reserves by improving the production and pricing mechanisms applicable to such reserves.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. PRODUCTION RATE.

Section 7422(c) of title 10, United States Code, is amended by adding at the end thereof the following new paragraph:

"(4) For the purpose of enhancing the value of the Naval Petroleum Reserves Numbered 1, 2, and 3, the President may establish a production rate for such Reserves that is less than the maximum efficient rate and that is consistent

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with sound engineering practices and the protection, conservation, maintenance, and testing of such Reserves, if the President determines that such rate is in the interest of national energy policy, taking into consideration—

"(A) the energy security of the United States (including the fill rate of, and quantity of petroleum in, the Strategic Petroleum Reserve);

"(B) prevailing local market conditions (and the effect of such conditions on the Strategic Petroleum Reserve and Naval Petroleum Reserves Numbered 1, 2, and 3); and

"(C) the effect of such production rate on the maximum amount of revenues which could be realized from Naval Petroleum Reserves Numbered 1, 2, and 3.".

SEC. 2. PRICING REFORMS.

(a) IN GENERAL.—Section 7430 of title 10, United States Code, is amended by adding at the end the following new subsection:

"(m)(1) The Secretary shall establish a minimum price for the sale of the United States share of petroleum produced from Naval Petroleum Reserves Numbered 1, 2, and 3 at an amount not less than the prevailing local market price at the time of sale for comparable petroleum in the area.

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"(2)(A) With respect to any sale or other disposition of such petroleum, the Secretary shall receive bids in the manner provided for in this section. After receiving such bids, the Secretary shall, for the purpose of obtaining the maximum value of such petroleum, determine the manner in which the petroleum is to be disposed. In making such determination, the Secretary shall take into consideration—

"(i) the bids received for such petroleum; and

"(ii) the amount that could be received for such petroleum by—

"(I) using it, or exchanging it for other petroleum, to fill the Strategic Petroleum Reserve;

"(II) selling it under or in relation to futures contracts; or

"(III) selling it in markets other than local markets.

"(B) The Secretary may provide for a fixed price for such petroleum over the term of the contract for sale.".

(b) CONFORMING AMENDMENT.—Section 7430(b) of such title is amended by inserting "except subsection (m)" after "provision of law" in the first sentence.

SEC. 3. ELIMINATION OF CERTAIN RESTRICTIONS.

(a) REPEAL OF RESTRICTION ON THE AMOUNT OF PETROLEUM FROM THE RESERVES THAT MAY BE PUR-

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CHASED BY A PERSON.—Section 7430(c) of title 10, United States Code, is repealed.

(b) EXEMPTION FROM EXPORT RESTRICTIONS.—Section 7430(e) of such title is amended to read as follows:

"(e) To maximize the value of the United States share of petroleum from the Naval Petroleum Reserves Numbered 1, 2, and 3, the President may exempt such petroleum from any export restriction to the extent that the President determines that such exemption is in the national interest.".

SEC. 4. PROVISIONS RELATING TO MAXIMUM EFFICIENT RATE AT NAVAL PETROLEUM RESERVE NUMBERED 1.

Section 7422(c) of title 10, United States Code, as amended by section 1 of this Act, is further amended by adding at the end thereof the following new paragraph:

"(5)(A) Not later than 30 days after the date of the enactment of this paragraph and periodically thereafter as the Secretary determines necessary, the Secretary shall, after consultation with the private owner of lands or interests within Naval Petroleum Reserve Numbered 1, establish maximum efficient rates with respect to formations within such Reserve.

"(B) During any period in which the production rate is less than the maximum efficient rate for any formation within Naval Petroleum Reserve Numbered 1, the Secretary shall

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provide that the private owner of lands or interests within such Reserve shall receive the amount of production from each formation that it would receive if petroleum were being produced from that formation at the maximum efficient rate. During the next period in which petroleum is produced from such formation at the maximum efficient rate, the Secretary shall provide for a reduction in the amount of petroleum received by such owner to the extent that the owner has received, pursuant to the preceding sentence, an amount in excess of its ownership interest in the formation concerned.".

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Mr. SHARP. I thank the distinguished gentleman. Does the gentleman from Indiana have an opening statement?

Mr. MCCLOSKEY. No, thank you, Mr. Chairman.

Mr. SHARP. The Chair now welcomes our first witness, the distinguished Member from California, Mr. William Thomas, who represents the district in which the reserve is located.

Mr. Thomas, welcome.

STATEMENT OF HON. WILLIAM M. THOMAS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. THOMAS. Thank you very much, Mr. Chairman. First of all, thank you for the joint session. It is an area in which you have to place a foot in either committee, given the uniqueness of this particular resource that we have.

In addition, I notice in the description of the bills, my bill, H.R. 4859, is described as a bill to enhance the value of the naval petroleum reserves by improving the production and pricing mechanisms applicable to such reserves.

However, the chairman's bill, H.R. 4843, is described as amending the Energy Policy and Conservation Act for the purpose of improving national energy policy. I fully understand the broader implications of your approach, but I do appreciate the opportunity to present my views.

I have been very concerned with production at Elk Hills for some time. In fact, in the last Congress I introduced a bill dealing with a defense petroleum reserve, utilizing Elk Hills oil.

I think that recent events, and especially the rapid downturn in the price of oil, require us to reconsider some of the statutes governing management of Naval Petroleum Reserve No. 1, and the management process itself.

I think we have to consider some changes. But having said that, I also want to add that Congress really has to exercise some caution in this area, because Elk Hills' impact on western U.S. oil production is huge. It is beginning to be better appreciated, but I still think we need to underscore the fact that this is the second largest oil field in the Western United States.

It has nearly 700 million barrels of recoverable crude oil. Much of it of a very high quality, which is extremely valuable. It complements some of the heavier crude and higher sulphur content production in an area that is a heavy producer of oil.

Last year in my district, over 250 million barrels of oil were produced. I am fond of saying that Kern County produces more oil than the entire State of Oklahoma, but it is true.

Elk Hills output accounted for almost 48 million barrels of that, but in addition there was considerable natural gas produced, which allowed for enhanced recovery, tertiary recovery, in a way which would not otherwise be permissible because of the air quality standards in the valley and in California.

So, the reserve plays a very significant role in the local economy. You have almost a thousand people employed at the reserve itself, but when you have the ripple effect from the Elk Hills oil through the pipelines, refineries, the private producers, whatever happens with Elk Hills heavily impacts the area.

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It is important to refiners and pipeline operators in the area. Secretary Herrington's program to reevaluate production levels obviously sends a ripple through the entire economy.

Given these relationships, as we examine the legislation that we have before us, my intent was to try and outline what we perceived as the problems and offer some suggested solutions. I have no pride of authorship in anything that is ultimately done, whether it be by administrative decision or ultimately by statute.

But when you consider some of the options available to us, such as the level of production of an operating oil field, I really think that ought to be left to petroleum engineers. We have had some recent publicity over the question of maximum efficient rate, and Secretary Herrington's reevaluation of the maximum efficient rate of production I think is a step in the right direction.

But I think we can spend some time talking about price. There are divergent views on what ought to be done, and also on the timing of contracts.

I think we have to protect this public asset, and we should ensure that production disputes are openly discussed. There is plenty of trouble in the oil patch right now to go around, and we don't need to point fingers as to whether it is the producers, refiners, or whoever else.

I want to focus on some options that we may have available to us, and I have done a lot of discussing with producers—smaller producers and others, and refiners. Historically, the Department has used an average of the top three posted prices as a benchmark for local market prices when the Department made sales, and by and large this has worked pretty well. Prices have been stable for a long time.

There was a period in which posted prices wouldn't change for a year or more, but since the beginning of the year you have had a rapid decline in prices, posted prices changed almost a dozen times in that period. Normally buyers are anxious to get the higher quality Elk Hills oil, and they pay a premium.

We have seen recently, however, as indicated by Chairman Nichols, that the sales system doesn't work very well when prices begin to fall rapidly. We had noted the sale price at about $4.50 below posted prices.

One of the things I think we have to focus on is that partial shut-in authority, I think, needs to be extended, so that you don't simply do a maximum efficient rate production, however that might be defined, or a shut-in.

One of the concerns that I have gotten is that the Government affects the market of oil in California far more than any other factor. Both with the production of Elk Hills oil at whatever maximum efficient rate might be, and with the introduction of North Slope oils into Wilmington, the Government is the primary definer of what the price of West Coast oil is going to be. It seems to me that both for a reasonable use of the reserve and maximizing its production to the Government, that there ought to be something less than maximum efficient rate, a partial shut-in power shall be available.

I think it is interesting to note that the 20 thousand barrel reduction that the Secretary of Energy has recently decided on is not

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because of some ability for a partial shut-in, but a reevaluation of what a maximum efficient rate might be. My bill provides for the opportunity for adjustments in production rates considering local market conditions, ultimate recovery, and maximizing the value of the reserve.

Second, we talk about instituting two types of pricing reforms, and I am really less concerned about whatever particular agreement we may come up with on a pricing mechanism.

I know the Department is very concerned about being left with unsold oil, and therefore is very sensitive about a posted price or a floor price, because if someone isn't willing to pay it, they don't believe they have the capacity for storing oil that has been produced.

I am sensitive to that, but I am also concerned about that being a mentality which creates an opportunity for folks to take advantage of the prices by virtue of not having some kind of a reasonable market price.

In investigating what a market price is, I think we have more problems than some people might realize to determine what a true market price is for California crude, or for any crude at any given time. Our posted prices are not what some people may think they are, especially when you have companies buying oil for themselves at prices lower than their own posted prices.

So, it is a very confused market situation. It seems to me that the primary value of our focusing on adjustments that can be made rapidly in time for a July sale is to examine the question of the management of the fields, and the question of bidding and contract times.

I think it is entirely reasonable to shorten the contract bidding period to a 30-day to 45-day period. I would prefer 30 days. In talking with refiners and others, that is a reasonable timeframe for them to get their bookkeeping in order to make sure the money is available for loans. The Government may need a slightly longer period of time than that to go through the procedures that they require, but certainly no more than 45 days.

The twice a year sales period is, I think, the primary culprit in the changing market for oil. That is why I say I am less concerned about the prices than I am about the bidding period and the contract period, because the shorter the contract period, the easier it is to correct any mistakes in the pricing mechanism if you repeat it several times during the year.

I think a quarterly contract period is one that would be amenable to a large number of people. I know some producers have talked about a shorter period than that. For example, six times a year, 60 days, and it may be possible to talk somewhere between quarterly and 60 days.

My concern is that there may be some individuals dealing with Government itself, for example, that have contract periods of up to 1 year, whether it be the Department of Defense for jet fuel, or for local governments in terms of supplies of gasolines or others, in which they are required by the Government to contract for a yearly period, but then the Government will only sell them oil on a 60- or 90-day basis, and it is extremely difficult to try to reconcile the two arrangements between governmental units, especially if it is the Federal Government doing both.

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But I think if we focus primarily, initially, on the question of contract period and bidding, shorten it to a 30- to 45-day period as I said, perhaps quarterly on the contract, then it is less important to come up with a formula for determining price.

I am very concerned about an artificial formula. A complicated formula that is difficult to understand. I think it is easier to come up with a market-oriented procedure which is easy to understand and shorten the contract period to make sure that we don't get into the same problems that we are in.

But DOE has tremendous discretion on handling sales procedures, and many of the recommendations that we focused on in both of our bills really could easily be accomplished by administrative change.

I am anxious that it occur before the next round of bidding. I look forward to examining the long-term problems, as Chairman Nichols indicated in terms of actual production itself, but those questions, I think, will be faced as we address the question of what Elk Hills is worth, and whether or not we are actually going to sell it.

For the July period coming up, I think, these hearings will be valuable in focusing on what can be done in the timeframe we have available. That I think, primarily, is in shortening the bidding and the contract period, Mr. Chairman.

Thank you, Mr. Chairman.

Mr. SHARP. Thank you very much. I appreciate your testimony. Let me ask my colleagues if they think they are going to have questions for Mr. Thomas.

Mr. NICHOLS. I think it is a very good statement.

Mr. THOMAS. Mr. Chairman, I ask unanimous consent that my written statement which goes into far more detail, be placed in the record.

Mr. SHARP. We certainly will make that a part of the record, and the subcommittee will stand in recess for 15 minutes.

Thank you.

[Brief recess.]

[The prepared statements of Mr. Thomas and Senator Lloyd Bentsen follow:]

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Statement of the Honorable
WILLIAM M. THOMAS
20th Congressional District, California
June 11, 1986

I appreciate this opportunity to present my views on a matter of such importance to people in my congressional district. The time has come to reconsider the statutes governing management of Naval Petroleum Reserve No. 1 (Elk Hills). Our colleague, Chairman Sharp, and I have each introduced bills that give the Department of Energy more flexibility in running the Naval Petroleum Reserve system. Recent events show some changes ought to be considered.

Having said that, I must also add that Congress must exercise caution. Elk Hills' impact on western U.S. oil production is huge. This is the second-largest oil field in the western United States. It has nearly 700 million barrels of recoverable crude oil, much of the oil being light, low sulfur crude. Last year, the oil producers in the Kern County portion of my district produced over 250 million barrels of oil. Elk Hills' output accounted for 47.7 million barrels of that and its natural gas undoubtedly contributed to the production of an additional 60,000 barrels per day of heavy crude.

The reserve also plays other significant roles in the local economy. Nearly 800 people are employed at the reserve itself, and others employed with pipelines, refineries and private producers are heavily impacted by what happens there. It is important to refiners and pipelines operating in the area, as their comments about Secretary Herrington's program to reevaluate production levels have shown.

Given these relationships, I urge that any legislation be moved forward after careful consideration of the evidence on western oil markets and production problems. Some concerns, such as the level of production of an operating oil field, ought to be left to petroleum engineers. Secretary Herrington's reevaluation of the Maximum Efficient Rate of production is a step in the right direction. In other matters including pricing, views diverge over what represents the best means of valuing California crudes.

Congress does have to protect the value of this public asset. We should ensure production disputes are openly discussed and settled under sound procedures. Elk Hills impact on local oil production and the human and capital assets needed to promote future exploration and development is significant from the viewpoint of this country's energy needs. We have another obligation as well: making sure the public gets the top dollar for its oil. Recently that, unfortunately, does not appear to have been taking place.

Historically, the Department has used an average of the top three posted prices as a benchmark for local market prices when the Department made sales. Buyers have bid for parts of the government's share of this crude in relation to postings. From the government's standpoint, this system worked fairly well for a long time. Buyers anxious to get high-quality Elk Hills oil have consistently paid premiums in order to get it. The public got a high price for its oil. Unfortunately, the postings-based sales system does not work as well when prices begin to fall rapidly.

The latest contract led to crude being sold for an average of $4.46 below posted prices. Between the decontrol of oil in 1981 and February 1, 1986, postings changed infrequently. Refiners, expecting that posted prices would change as slowly as postings changed in the past, bid for oil at discounts because the refiners thought postings would take a while to reflect spot market trends. Since February 1st, postings have changed at least nine times. In attempting to anticipate the market's movement, the refiners' bids resulted in prices below what many independent producers consider to be the market price for crude of this quality. I am sure the witnesses from the California Independent Producers Association can detail some of the influence these low prices had on prices in the private sector, but we can all recognize that low prices for some of the best crude available anywhere can have a tremendous influence on prices offered for other crude from private companies.

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these events have raised great concern about whether the public is getting the most value for its oil.

My bill, H.R. 4859, answers some of the concerns that have grown out of these events. First, it provides partial shut-in authority so that the reserve can be produced at less than the "Maximum Efficient Rate" (MER) required by law. The present statute requires the Department to produce at a rate that maximizes the ultimate recovery from the reserves. Indeed, the Secretary of Energy's recent decision to reduce output by some 20,000 barrels per day is based on some of the lower estimates of the MER, not on any partial shut-in power. This bill requires lower production decisions to consider U.S. energy security, local market conditions, ultimate recovery and maximizing the value of the reserve.

Second, the bill institutes two types of pricing reforms. H.R. 4859 repeals current law provisions barring sales of more than 20% of estimated annual production to one customer and the prohibitions on exports. These provisions only limit bidding for Elk Hills crude today, depriving the government of a measure of competition that would help promote higher prices. Other pricing reforms involve the sales procedures themselves. H.R. 4859 makes local market prices the floor price: bids below posted prices could not be accepted. The bill goes farther by requiring the Department to maximize sales prices by considering alternative methods of disposal, including use to fill the Strategic Petroleum Reserve, sales in relation to commodity exchange indices, and sales outside the local market. The Department could also use fixed-price sales contracts.

Finally, the bill provides the private owner of a portion of Elk Hills with a compensating mechanism so that, in case partial shut-in is invoked, the company's operations are not needlessly disrupted. The company could get an amount of production based on its share of production under production at the Maximum Efficient Rate, but the government would be able to recoup some of that production by reducing the private owner's share once production at MER resumes.

The legislation meets some basic concerns about Elk Hills' management. It eliminates the "all or nothing" approach to production in favor of a more flexible approach that takes into account the public interest in local oil production and the value of the resource over its life. It also provides the Department of Energy with some basic guidelines and new flexibility in making sales in an effort to ensure that we do get top dollar for this crude. There are, however, other factors I hope will be considered as legislation in this area moves forward.

The primary focus of pricing and production reforms at this time must be the upcoming sale. Another sale of Elk Hills crude will be initiated this summer. Unless the Department adopts new sales procedures in a very short time, the bidding process will again rely on the posted price system producers and refiners seem to agree needs to be reformed.

One thing the Department can easily do under its present authority is shorten the contract procedures. Currently, the bidding process takes up to seventy-five days to complete. Added to the six month contracts used in the last sale, the bid process means buyers are guessing what refined product and crude prices will be as much as eight months before the contract ends. The Department should consider shortening both the bid period and the length of its contracts. I understand from discussions with refiners and producers that they believe bidding can be handled in a thirty to forty-five day period. Both groups also say that shorter contracts have to be considered. I am informed, for example, that some refiners could accept quarterly contracts.

DOE has tremendous discretion on handling sales procedures; many of the recommendations included in my bill could easily be accomplished today. However, that authority has to be used. In the past few weeks, producers, refiners and the Department have all proposed new sales procedures. I would hope they can resolve their differences and agree on a new pricing system that maximizes the value of Elk Hills crude while preventing it from being sold at below-market prices. If that does not occur, we should certainly consider giving the Department new guidelines under which to operate and sell crude from this reserve.

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STATEMENT BY
SENATOR LLOYD BENTSEN

BEFORE THE COMMITTEE ON ENERGY AND COMMERCE
SUBCOMMITTEE ON FOSSIL AND SYNTHETIC FUELS
HOUSE OF REPRESENTATIVES
JUNE 11, 1986

Mr. Chairman, Subcommittee Members:

I appreciate the opportunity to provide this testimony for the Subcommittee's hearing record. Chairman Sharp and the Subcommittee are to be congratulated for their aggressive steps to preserve Elk Hills as a valuable component of the United States energy resource base.

Elk Hills History of Reservoir Damage

Elk Hills or the Naval Petroleum Reserve Number One was acquired before World War I. Little production occurred initially. And it was opened for substantial production only in 1976 as one United States response to the oil crisis. It was opened under authority of the Naval Petroleum Reserve Production Act of 1976 (P.L. 94-258). In that law, Congress took special care to instruct the Department of Energy (DOE) that Elk Hills was not to be exploited. Production was to be moderate enough to ensure the capture of all recoverable oil, then estimated at about 1.4 billion barrels. Today, about one-half of that, or 700 million barrels remains.

To ensure maximum recovery, Congress instructed DOE to establish a Maximum Efficient Rate or MER for Elk Hills. MER is

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an engineering-based figure determined through geological analyses which set the maximum rate of withdrawal from a reservoir. That rate is designed to be one which will not damage or jeopardize the ultimate recovery of all recoverable oil from a pool. MER is an invaluable tool for prudent reservoir management. Without it, the tendency is to overproduce. Very rapid pumping from some reservoirs will not damage them. But in most instances, excessive pumping causes the viscous surface of oil to separate, leaving pools of oil isolated from the stream being extracted. This "fingering" can sometimes be rectified with expensive enhanced recovery techniques. But often the isolated pool remains lost forever and the reservoir damaged because of overproduction

MER's are designed to prevent reservoir damage and the loss of otherwise recoverable oil. P.L. 94-258 told DOE to develop an MER for Elk Hills. But it never did. Overproduction at Elk Hills first came to Congressional attention in 1984 when DOE submitted legislation to routinely reauthorize production for Elk Hills. That is done every three years and Congress granted the typical three-year extension through April, 1988. At that time, a preliminary GAO report tentatively raised the issue of excess production rates and possible oil loss at Elk Hills. But DOE officials denied there was a problem. Congress was assurred there was no reservoir damage. And Congress accepted their assurances pending further investigation.

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That investigation is now complete. And it found DOE in error. The investigation was conducted by the DOE Inspector General (IG). This IG's audit report extensively documented analyses verifying that oil has, in fact, been lost at Elk Hills through DOE overproduction. It is the definitive statement on this issue and worth reviewing.

Inspector General's Report

The DOE IG report documented a history of mismanagement and overproduction by DOE involving Elk Hills. It reached these conlusions:

* The DOE-developed MER Production Rates at Elk Hills were not engineering-based.

* The DOE has withdrawn oil since 1979 from Elk Hills at production rates which exceeded the MER calculated by its own engineers and consultants. Sometimes this withdrawal rate was twice the MER.

* As early as 1983, and possibly even as early as 1979, the DOE knew that excessive production rates at Elk Hills was damaging the reservoirs and isolating reserves, causing the recovery of 91 million to 128 million barrels of oil to be placed at risk. The damage was found to be so severe the one-half of that total, or from 45 to 65 million

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barrels of oil has already been irretrievably lost at Elk Hills due to DOE mismanagement. That staggering loss equals about 10 percent of the United States' Strategic Petroleum Reserves.

* Evidence of reservoir isolation and the loss of recoverable reserves was presented to DOE by the Reservoir Branch Manager, the Engineering Director, and the Elk Hills' Reserve Director in 1983. Yet, the DOE failed to slow production in order to enhance prospects for recovery of at least some portion of the losses resulting from excessive production.

* Engineering-based MER's have not yet been established for the reservoirs at Elk Hills by the DOE. Consequently, excessive production continues at the present time at Elk Hills.

In short, DOE violated the law in not devising an MER which is engineering-based; it overproduced Elk Hills despite the findings of recoverable reserve loss by its own engineers; and, it has yet to develop proper MER's for all the reservoirs at Elk Hills.

In response to this IG Report, Senator Gore and I joined in calling for an immediate rollback of production at Elk Hills to limit further reservoir damage. In addition, we initiated an

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investigation by the General Accounting Office (GAO) of the factors responsible for the abuse of Elk Hills. These steps generated substantial public pressure for action by DOE. In recent months, production at Elk Hills has exceeded 120,000 barrels daily. And I am delighted that the Department of Energy responded to our request and agreed two weeks ago to cut production at Elk Hills by 20,000 barrels daily to limit further reservoir damage.

Elk Hills Pricing

As the Subcommittee knows, Senator Wallop and I introduced S. 2375 on April 28, 1986, to remedy the give-away pricing practices at Elk Hills.

A major unfortunate effect of DOE overproduction at Elk Hills was the resulting need to move its oil regardless of the price. In today's weak market, that meant DOE is forced to sell at sharp discounts from market prices. Most of the oil from Elk Hills is high quality. Yet, DOE is selling it at discounts exceeding $4 per barrel. The average selling price now is $8.38 per barrel when comparable oil in Bakersfield is selling for $13. In some instances, DOE is selling into a weak market at prices ranging down to $6.48 per barrel.

Frankly, DOE was not exercising wise stewardship of a national resource entrusted to its care by Congress. Acting on

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Chairman Sharp's instructions, the General Accounting Office investigated these pricing practices, as well.

DOE responded on May 30 by proposing to revise its pricing practices. It has suggested four alternative methods designed to ensure that the Government receives full market value for its oil. And Chairman Sharp deserves congratulations for his successful effort to catch DOE's attention, particularly in introducing H.R. 4843, which called for pricing reforms at Elk Hills.

Subcommittee Hearing

In the past, DOE has stonewalled efforts to end its mismanagement there. And, it is clear that DOE would have taken no action to end the production and pricing abuses at Elk Hills without Congressional pressure. The pressure became too intense for that, in large measure thanks to courageous work by the IG's office within DOE. Changes at Elk Hills are in the wind.

And the legislation being reviewed today by the Subcommittee can materially move that reform process forward. It must address the Elk Hills pricing question, ensuring that market prices are received. And it should ensure that engineering-based MER's are developed and utilized by DOE to guard against further reservoir damage at Elk Hills. But this Subcommittee should go further, tackling an additional topic. It should thoroughly review the role Elk Hills can play in our strategic petroleum reserve. The

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cash-hungry Administration hopes to shrink the deficit by selling off long-treasured national assets, including Elk Hills. I am not convinced that a distressed sale of long-held American oil assets to reduce the deficit is wise. Moreover, I am firmly opposed to fire sale pricing of those assets.

In a report just released by the Chairman, the GAO found that Elk Hills could carry a market value of up to $9.1 billion if oil prices rebound. Yet, the Administration has rushed plans ahead to dump it at half that price. The Office of Management and Budget has proposed a price between $3 billion and $5 billion. My only reaction is bad price, bad place, and bad idea. And I encourage the Subcommittee to focus on the wisdom of selling Elk Hills at all in light of our burgeoning dependence on imported oil.

Foreign oil imports are up 600,000 barrels daily this year or 12 percent. Our dependence has jumped to 33 percent. And both the Congressional Budget Office and Library of Congress have concluded that foreign oil will be providing one-half of our oil imports by 1988. Even more alarming, 83 percent of that new foreign oil is from Organization of Petroleum Exporting Countries or OPEC. We are headed full-bore into the same dangerous level of oil dependence we experienced in the seventies. And Elk Hills may well have a significant role to play in national preparations to defend against future energy crisis that rising dependence may well bring.

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Mr. SHARP. Please come to order. The two subcommittees are now happy to hear from the Honorable Donald L. Bauer, the Acting Assistant Secretary for Fossil Energy with the Department of Energy. He is accompanied by Richard Furiga, the Deputy Assistant Secretary for Petroleum Reserves, and Capt. William Rumbold, USN, the Director of Naval Petroleum Reserves.

Gentlemen, we will be happy to hear from you at this point. Mr. Bauer, please proceed.

STATEMENT OF DONALD L. BAUER, ACTING ASSISTANT SECRETARY FOR FOSSIL ENERGY, DEPARTMENT OF ENERGY, ACCOMPANIED BY RICHARD D. FURIGA, DEPUTY ASSISTANT SECRETARY FOR PETROLEUM RESERVES: WILLIAM W. RUMBOLD, DIRECTOR OF NAVAL PETROLEUM AND OIL SHALE RESERVES; AND JAMES TILLMAN, PROCUREMENT OPERATIONS

Mr. BAUER. Thank you, Mr. Chairman.

Mr. SHARP. We will make your written statements a part of the record, and we will be happy to hear from you orally at this time.

Mr. BAUER. Thank you, Mr. Chairman, and good morning. It is my pleasure to appear before you this morning. I want to impress upon the committee this morning that Secretary Herrington is committed to developing both a production and a sales approach for the naval petroleum reserves that offers the most benefit to the taxpayer. I believe he has expressed that to you personally, and it is also stated in my formal statement, and I am here to state that I am to carry out that commitment, and I am prepared to do that in a most expeditious manner.

When concerns were raised that production of oil from the Elk Hills Reserve might be too high, and that the sales process had led to the marketing of undervalued oil, the Secretary acted very quickly within his existing authorities.

His actions on May 23, encompassed two broad policy objectives. No. 1, to ensure that oil production from the reserve reflected sound engineering practices and, No. 2, to ensure that the taxpayer receives the full market value of the crude oil.

To ensure that production was based on sound engineering practices, the Secretary approved the use of the most conservative engineering judgments in determining the maximum efficient rate, better known as MER, of production. That action resulted in the reduction of approximately 20,000 barrels per day of oil out of Elk Hills. The reduction in commercial sales has been prorated among the 13 companies buying oil from the affected delivery point. The Secretary also commissioned independent engineering evaluations of production rates of two of the fields major rate-sensitive reservoirs and accelerated the redetermination of MER's for the remaining Elk Hills reservoirs.

To ensure that future bidding procedures provide better safeguards for the taxpayer, the Secretary directed that a comprehensive review of the competitive bidding procedure be undertaken immediately. That action is in progress, and a task force is working on it as a high priority matter.

High priority. Why? Because he stressed that the appropriate changes be made in time for the next Elk Hills crude oil bidding

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cycle later this summer. This review is being conducted in the context of existing authorities, and if adequate safeguards cannot be implemented in this manner, it may be appropriate to review the existing statutes to determine if legislative changes should be proposed.

In short, Mr. Chairman, the Department has recognized that a process which served the taxpayer well during a time of oil market stability did not, and does not, offer the same benefits when the market is volatile and uncertain, and we are committed to modifying this system in a way that both serves the taxpayer and maintains the Government's standing as a credible business partner.

We do not believe it is in the best interest of our credibility, particularly for future oil sales, to terminate existing contracts solely for the convenience of seeking higher prices.

In the long run, that action could have a chilling effect on the willingness of future bidders to view the Government as a good faith business partner.

On the other hand, we do believe that it is imperative to structure future sales methods, beginning with the next cycle, so that the taxpayer receives the full market value of an asset entrusted to our oversight.

That is the Secretary's directive, and I can assure you that we are carrying it out on a high priority basis.

And finally, Mr. Chairman, in your letter of invitation you asked for a copy of the memorandum of law dealing with the Strategic Petroleum Reserve. I am pleased to deliver that to the Committee, at this time, a final copy of that memorandum, and submit it to recorder for inclusion into the record.

Thank you, Mr. Chairman, and I will be pleased to answer your questions at this time.

[Testimony resumes on p. 49.]

[The prepared statement and attachment of Mr. Bauer follow:]

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Testimony of Donald L. Bauer
Acting Assistant Secretary for Fossil Energy
U.S. Department of Energy
to the
Subcommittee on Fossil and Synthetic Fuels
House Committee on Energy and Commerce
and
Subcommittee on Investigations
House Armed Services Committee

June 11, 1986

The Subcommittees have asked us to review the recent sale of oil from the Elk Hills Naval Petroleum Reserve No. 1 and to discuss the decisions made by Secretary Herrington on May 23, 1986. We are pleased to respond to this request, and we hope the following information will illustrate our commitment to developing both a production and a sales approach for Naval Petroleum Reserve oil that offers the most benefit to the taxpayer.

The Secretary's actions last month encompassed two broad policy objectives: (1) to ensure that oil production from the Elk Hills Reserve reflects sound engineering practices; and (2) to ensure that the taxpayer receives the full market value of the Reserves' crude oil. The actions, which I will discuss more thoroughly in a moment, include steps that were implemented immediately as well as several comprehensive reviews that could lead to further changes in our production and sales practices.

Before describing the specific decisions made by the Secretary, it may be useful to review briefly the background of the Naval Petroleum Reserves and the statutory requirements that govern the production and sale of their crude oil output.

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BACKGROUND

Although established in the early 1900s, the Naval Petroleum Reserves produced significant quantities of oil only sporadically until the mid-1970s. Prior to July 3, 1976, the Reserves, which were under the jurisdiction of the Department of the Navy, were essentially in a shut-in status with only minimum production.

In the aftermath of the 1973-74 Arab oil embargo, Congress passed the Naval Petroleum Reserves Production Act of 1976 (Public Law No. 94-258) which required that the Reserves be produced at their "Maximum Efficient Rate" -- a term defined by law -- and that oil be sold in free and open competition, except for the discretionary authority to set aside 25 percent of production for small refiners. The statute provides that under fully competitive sales, the oil must be sold to the "highest qualified bidder", and in set-asides, "at not less than prevailing local market price."

The Navy implemented the statutory directives through essentially the same sales procedures they had been using prior to passage of P.L. 94-258, including soliciting bids comprised of bonuses and discounts to a "base price." The base price was the highest posted price for crude oil of like quality from oil fields near the Reserves. To comply with the 1976 Act, the Navy modified the sales procedures to include, for example, the required 30 day Justice Department antitrust review. While additional minor

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modifications have been made subsequently, this system of bidding bonuses and discounts to a "base price" remained basically unchanged and was retained by the Energy Department when the Reserves were transferred to our jurisdiction in 1977.

To conduct a fully competitive sale, the Department issues Invitations for Bids approximately 90 days prior to contract deliveries. This allows 30 days for prospective purchasers to develop their bids, 30 more days as required by statute for Department of Justice antitrust review of proposed contracts, time for bid evaluation and sufficient time for contractors to establish letters of credit and make transportation arrangements. These procedures necessarily differ from those used in commercial transactions and require a longer lead time between bids and actual oil delivery, but the process has provided the Government with certain assurances that private producers may not receive.

When the Department of Energy assumed responsibility for the Reserves, it retained the concept of using regional posted prices as the benchmark for establishing the "base price," although in 1980 it opted to use the average of the three highest posted prices rather than the single highest price.

Unlike most industries in which sellers set prices and buyers search for the best price, the domestic oil industry has for decades used the system of price posting. The buyers of oil -- usually refiners -- publish or "post"

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the prices they are willing to pay for crude, and producers seek the best price for their crude. In California, the prices are field-specific and vary according to the quality of the oil, the cost of transportation for the posting firm, and other factors.

Knowledge that posted prices are the foundation of many private contracts has helped reinforce confidence that the Government's "base price" for NPR oil would generally track market trends. This encouraged broad participation by potential buyers and ensured that the Government could dispose of the oil it statutorily was required to produce at the "Maximum Efficient Rate." The need to ensure a sufficient number of bidders is particularly important in view of the fact that limited storage capability at the Reserve necessitates that the Department sell all oil produced.

In times of stable or rising oil prices, this bonus/discount bid procedure served the taxpayer well. Nearly $290 million in net bonuses over the prices posted in the Elk Hills area have been deposited in the Treasury since 1980 (through March 1986). This amount is in addition to the more than $7.5 billion that has resulted from total sales of oil, natural gas and liquid products from the Reserves. Posted prices, while reflecting long-term market trends, did not move erratically to reflect daily variations in the oil spot market, and over time this fact has tended to allow both the Government and its customers to forecast cashflows accurately.

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Several times during the last decade, however, spot prices have shifted dramatically for short periods of time, resulting in significant deviations from the relatively stable average posted prices. In times of world oil supply disruptions, the result was substantial bonuses in bids for Elk Hills oil. But more recently when oil prices began to fall rapidly and the oil industry became increasingly uncertain about the ultimate depth of the price plunge, bidders for NPR oil sought, through heavy bid discounts, to protect themselves from current and unforeseeable future reductions in spot market prices below the levels of posted prices. From the standpoint of ensuring that the taxpayer was receiving full market value for Reserve oil, the use of posted prices as a benchmark in our oil sales clearly had gotten out of step with the rapidly changing marketplace.

A review of the California spot market during the month of January 1986 -- when bids were due for the six-month delivery cycle beginning April 1, 1986 -- reveals the volatility that compounded bidders' uncertainty and, perhaps more than anything else, contributed to the heavily discounted bids.

In the early part of January, two to three weeks before bids were due, posted prices and spot market prices for crude oil moving out of the San Joaquin Valley to Los Angeles were virtually identical. However, as world crude oil prices continued to fall that month, the spot market price in California mirrored the drop, and a gap opened between the postings and the spot prices. During the week prior to the January 27, 1986, bid opening,

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spot market prices collapsed, and the differential between posted and spot prices widened to approximately $7.00 per barrel.

In theory, contractors knew that if this differential lasted for any significant period, posted prices would drop to reflect the trend. However, there was great uncertainty among many bidders as to whether the spot market would stop falling during the six-month term of the contract. Many bidders feared that spot market prices would fall continuously for the entire term of the contract and that posted prices, even as they adjusted, would remain above the falling spot market.

This outlook led to the majority of bidders offering unprecedented discounts in an attempt to minimize or eliminate the differential between postings and spot prices that existed on the bid date or that might develop in the future if spot prices continued to fall.

The Department recognized the potential for selling undervalued oil at the time the discounts were received. However, several factors weighed heavily in our decision to accept the bids for contracts. First, the volume of bids for oil was very high -- bids were received for 186,333 barrels of oil per day although we offered only 82,000 barrels of oil per day -- indicating that the bidding was highly competitive. Second, the reasons behind the bidders' substantial discounts were also rational and understandable, and it was reasonable for bidders to predict that postings

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might not fall as far as spot prices or that spot prices might continue to fall for the entire contract term. Third, on the day of bid opening, the Elk Hills oil prices substantially exceeded prevailing regional spot prices even if the average $4.40 discount was included in the calculations. Fourth, as previously stated, the Department was required to sell the oil produced at "maximum efficient rate" and limited storage capacities prohibited any substantial delay required to reissue an invitation for bids. And finally, there was no reason to expect a more preferable outcome from a re-solicitation, even if that had been considered practicable, nor did it seem fair for the Government to unilaterally extend existing buyers' contracts to their detriment.

With the benefit of hindsight, it is now apparent that accepting the discount bids in January resulted in the delivery of underpriced oil when compared to trading prices of recent weeks. Nevertheless, from the vantage point of early February, it was not at all a foregone conclusion that the bids would cause Elk Hills oil prices to deviate significantly from spot prices during the term of the contract.

When it became apparent that the taxpayer was not receiving full market value for oil sold from Elk Hills, the Secretary acted quickly to avoid a recurrence of the problem.

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THE SECRETARY'S MAY 23 ACTIONS

As stated earlier, the Secretary's actions on May 23, 1986, had two major policy objectives: (1) to ensure that oil production from the Reserve reflected sound engineering practices; and (2) to ensure that oil sales were returning full benefits, in terms of revenue, to the taxpayer.

The first objective stemmed from concern that the Elk Hills field was being produced too rapidly, possibly leading to a loss of ultimate oil recovery. As an immediate measure, the Secretary approved a reduction of 20,000 barrels per day of oil from Elk Hills, an action which reflected the application of the most conservative engineering judgments for determining the "Maximum Efficient Rate" (MER) of production.

Effective June 1, Elk Hills production was reduced from the originally intended level of 126,000 barrels per day to 106,000 barrels per day. The reduced output has the effect of cutting back from 83,000 barrels per day to 68,000 barrels per day the amount of oil the Department is selling to private purchasers. Contracts with these purchasers contain a clause which provides for reduced production to be prorated among the contractors according to the ratio of the contract volumes at the affected delivery locations to the total amount contracted. In this case, the reduction is from two pools whose production goes to a delivery point known as the 18G Lease Automatic Custody Transfer point. The Government has contracted with 13 companies to take delivery from that location, and the proration is taking place among those companies.

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The sale of 15,000 barrels per day to the Department of Defense was unaffected by the reduction, while oil deliveries to Chevron Inc., which jointly owns the Elk Hills field with the Government and receives about 22 percent of its output, is being reduced from 28,000 barrels per day to 23,000 barrels per day.

Statutorily, the reduction was within the Department's discretion because the new levels of production remain within the range for the mandatory MER level. MER, while both required and conceptually defined by Public Law No. 94-258, is not a precise number. The Act defines MER as "the maximum sustainable daily oil or gas rate which will permit economic development and depletion of that reservoir without detriment to ultimate recovery."

To determine MER, the Department uses its own engineering staff, engineers from our operating contractor, and several highly respected petroleum consultants. Each major reservoir within an oilfield has its own MER; at Elk Hills, an MER is established for each of 15 reservoirs. While MER is a well-understood concept in the petroleum industry, there often are legitimate differences in opinions among petroleum engineers as to what the MER should be for a given reservoir. Typically, the result is a wide range of MER recommendations.

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Historically, the Department has set the actual production rates for Elk Hills reservoirs at roughly the middle of this range of estimates. Since January 1985, the procedure for determining and approving MER has been carried out in a systematic manner under the guidelines of a formal set of procedures. A principal purpose of these procedures is to ensure that all engineering recommendations for each reservoir's MER are fully considered before the final MER is approved.

The Secretary's May 23rd decision reduced production at Elk Hills to the lower portion of the range for MER recommendations. The authority to take this action resides primarily in two subsections of Public Law 94-258 (Section 7422 of Title 10, United States Code):

> (a) The Secretary, directly or by contract, lease, or otherwise, shall explore, prospect, conserve, develop, use, and operate the naval petroleum reserves in his discretion, subject to the provisions of subsection (c) and other provisions....
>
> * * * *
>
> (c) [T]he Secretary is authorized and directed --
>
> * * * *
>
> (B) to produce such reserves at the maximum efficient rate consistent with sound engineering practices....(Emphasis added)

The production levels approved by the Secretary are supported by the more conservative of the engineering judgments for MER and, therefore, are fully consistent with sound engineering practices.

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The Secretary also commissioned an independent engineering evaluation of production rates of two of the field's major reservoirs -- the Main Body B/Western 31S reservoir (36,300 barrels per day) and the 26R reservoir (31,900 barrels per day) -- which account for nearly 60 percent of Elk Hills' total production. The reports from these external consulting firms will be used to validate MERs for these two rate-sensitive reservoirs. Also, the formal review and approval of MERs for the remaining Elk Hills reservoirs will be accelerated by approximately one month with scheduled completion in September 1986.

In carrying out the Secretary's directive to ensure that the taxpayer receives full market value of crude oil sold from Elk Hills, we have undertaken a comprehensive review of the current competitive bidding process. A task force of personnel from the Department's Procurement Office, General Counsel, and the Petroleum Reserves office is now reviewing the entire sales methodology and will propose changes which we hope will ensure that future sales of Reserve oil bring the fair market price and remain consistent with changes in the oil market.

The task force is (1) examining the terms of the Invitations for Bids, (2) considering different lengths of time for contracts, and (3) examining several alternatives for pricing the oil which are not dependent upon posted prices. Several of the alternatives and possible changes to contract terms have been made available to the companies on our bidders' list, and many have made helpful comments and suggestions. Changes in the bidding provision will

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be implemented for the next Elk Hills delivery cycle which begins October 1, 1986.

Regarding changes that could be made prior to the receipt of new bids, the contracts for selling crude oil have clauses that would allow the Government to terminate the contracts at its convenience. However, such termination could compel a resale before we have adequate time to assure ourselves that a new sales methodology will produce better results for the taxpayer. Also, in addition to alienating our current customer base, terminating contracts prematurely in hopes of attaining higher prices could undermine the integrity of future crude oil sales. In short, the potential risks in terminating contracts outweigh any potential benefits. Therefore, we do not intend to take any action at this time to terminate existing contracts.

Regarding the need for legislative changes, the Department believes that adjustments in either current production levels or sales procedures should initially be examined within the context of current statutory requirements. When these reviews are completed, if adequate safeguards to the taxpayer still cannot be assured, it may be appropriate to review the existing statute to determine if legislative initiatives should be proposed. Since we are still implementing the Secretary's directives, it is too early to tell whether further modifications requiring legislative changes may be necessary.

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The question contained in the Subcommittee's letter of invitation regarding estimates of total lost revenue from the sale of Elk Hills oil requires that we compare Elk Hills crude oil prices to other private contract prices. The difficulty of comparing NPR contract prices with relevant actual commercial contract prices is compounded by the paucity of publicly available data on commercial contract prices for comparable oil.

Also, calculations based on the differential between the Elk Hills contract prices and the posted prices used in our base price formula may not lead to a valid comparison. Posted prices are not firm commitments to buy oil, and in today's unstable market, they may not necessarily equate to contract prices actually negotiated between commercial entities. In California particularly, prices are posted in oil fields by numerous companies, and there can be a wide range among the postings, especially in times of rapid market changes. For example, we use an average of the three highest postings in certain fields, but within the last few weeks, there has been nearly a $3.00 per barrel difference between the high and low postings in those fields.

The Committees also asked us to review and comment on H.R. 4843 and H.R. 4859, draft bills which would increase the Government's flexibility in establishing production rates for the Naval Petroleum Reserves.

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The Department agrees in general that there are certain aspects of the existing legislative framework which may inhibit the management of the Reserves in the most prudent, businesslike manner over the long term. In fact, a rationale for the Administration's proposal to divest itself of the Elk Hills and Teapot Dome Naval Petroleum Reserves has been that a private owner might value the Reserves higher than the Government because of its ability to manage these assets without the legislative constraints which govern federally-run operations.

But because the issue of prospective legislative changes could have a bearing not only on short-term production and sales of NPR oil but also on the longer-term outlook for divestiture of the fields, I would appreciate the opportunity to submit specific comments and suggestions regarding the two bills at a later date, once the ongoing review of the sales process has been completed and we have had the opportunity to review the bills more thoroughly in the context of our asset divestiture initiatives.

Also, in the Committee's letter of invitation, you requested the Memorandum of Law related to the question of amending the Strategic Petroleum Reserve Plan. A copy of this Memorandum of Law is being provided to the Committee along with this testimony.

This concludes my prepared statement.

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Department of Energy
Washington, DC 20585

June 9, 1986

Memorandum for Donald L. Bauer
Acting Assistant Secretary
for Fossil Energy

From: J. Michael Farrell
General Counsel

Subject: Amendment of the SPR Plan to Report the SPR Moratorium

You requested our opinion whether the Energy Policy and Conservation Act (EPCA), Pub. L. No. 94-163, requires that the oil storage schedule contained in the SPR Plan be amended, in order for the Administration to implement a moratorium on SPR fill and construction. In our opinion no SPR Plan amendment is required in order for the Executive Branch to revise SPR fill goals because, as shown below, the pertinent provisions of EPCA have been superseded by subsequent legislation whose provisions with respect to the storage schedule conflict irreconcilably with the schedule contained in the SPR Plan.

Discussion

In §154(c)(1) of the EPCA, 42 U.S.C. §6234(c)(1), enacted in December 1975, the Congress adopted a schedule for fill of the SPR which was to be included in the SPR Plan and to be followed, "to the maximum extent practicable and except to the extent that any change in the storage schedule is justified pursuant to subsection (e)(6)...." Subsection (e)(6) provides that the SPR Plan is to contain, "a justification for any changes, with respect to volumes or dates, proposed in the storage schedule...." The schedule set out in §154(c)(1) is expressed in terms of the periods of time within which the Government is to store amounts of crude oil equal to specified percentages of the crude oil imported during a base period, which was the three consecutive months during the 24 months preceding enactment of the EPCA in which average monthly imports were the highest.

The Federal Energy Administration, a predecessor agency to DOE, calculated that §154(c)(1) required fill to be accomplished on the following schedule:

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Date	Million Barrels (MMB)
June 22, 1977	50
Dec. 22, 1978	150
Dec. 22, 1980	325
Dec. 22, 1982	500

Because the initial 1977 target had proved impossible to meet, the original SPR Plan transmitted to Congress in February 1977 dropped that requirement; the other three statutorily derived fill targets were incorporated into the Plan without change.

Amendment No. 1 to the SPR Plan, transmitted to the Congress in May 1977, accelerated the SPR Plan's fill schedule as follows:

Date	MMB
June 22, 1978	250
Dec. 22, 1980	500

And Amendment No. 2, transmitted to the Congress one year later, further amended the SPR Plan to provide for storage by the end of 1985 of the full one billion barrels of crude oil authorized by the EPCA; the amendment detailed plans for the storage of 750 MMB of this billion, and said that with respect to the last 250 MMB, decisions had not yet been made about the type of storage facilities to be used or the extent of industry involvement (i.e., whether to mandate industry storage).

However, SPR fill was halted in 1979 in the aftermath of the Iranian supply disruption, when only 91.7 MMB were in SPR storage. Despite Congressional entreaties to resume fill, no plans to resume fill were developed and the SPR fell far behind the ambitious schedule contained in the SPR Plan.

To overcome this resistance, in June 1980 the Congress enacted the first of a series of laws concerning the rate at which the SPR should be expanded. The Energy Security Act, Pub. L. No. 96-294, added to §160 of the EPCA a new subsection (c) directing the President to assure that SPR fill was increased to an average rate of at least 100,000 barrels per day (b/d) in each fiscal year commencing with fiscal year 1981; it further added a new subsection (d) effectively compelling a shut-in of Naval Petroleum Reserve No. 1 at Elk Hills, California, if this fill rate was not achieved. The shut-in sanction would remain applicable until 500 MMB of crude oil were stored in the SPR.

In December of 1981 the Congress added to the 1981 Department of the Interior and Related Agencies Appropriations Act, Pub. L. No. 96-514, a requirement that the President "seek to" undertake SPR fill activities "at a level sufficient to assure" that crude storage is increased at an average annual rate of at least

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300,000 b/d "or a sustained average annual daily rate of fill which would fully utilize appropriated funds."

Congress reenacted essentially the same 300,000 b/d "seek to" requirement in August 1981 in the Omnibus Budget Reconciliation Act, as an amendment to EPCA §160(c), but without the reference to a sustained average "which would fully utilize appropriated funds." The 300,000 b/d "seek to" requirement was made applicable until 750 MMB were in storage.

On August 3, 1982, the Congress enacted the Energy Emergency Preparedness Act, Pub. L. No. 97-229. Among other things it superseded the Budget Reconciliation Act's 300,000 b/d "seek to" requirement by a new fill mandate. This was set forth as an amendment of §160(c) of the EPCA reading as follows:

> (c)(1)(A) The President shall immediately undertake, and thereafter continue, petroleum products acquisition, transportation, and injection activities, to the extent funds are available pursuant to section 167(b)(2) and (b)(3), at a level sufficient to assure that the petroleum products in the Strategic Petroleum Reserve will be increased at an average annual rate of at least the minimum required fill rate until the quantity of petroleum products stored within the Strategic Petroleum Reserve is at least 500,000,000 barrels.
>
> (B) Subject to subparagraph (C), the minimum required fill rate shall be 300,000 barrels per day for purposes of subparagraph (A), unless there is in effect a finding by the President in his discretion for good cause that compliance with such rate would not be in the national interest. Any finding by the President under this subparagraph takes effect on the date such finding is transmitted to the Congress and ceases to have effect at the end of the fiscal year in which such finding was made. Any such finding transmitted to the Congress shall include a statement of the facts upon which the finding is based. Any such finding shall not be subject to judicial review.
>
> (C) The minimum required fill rate shall be 220,000 barrels per day for purposes of subparagraph (A) during the period in which any finding by the President under subparagraph (B) is in effect.
>
> (D)(i) If funds are available in any given fiscal year after fiscal year 1982 to achieve an average annual fill rate higher than the minimum required fill rate under subparagraph (C), the minimum required fill rate shall be be highest practicable fill rate achievable, subject to the availability of appropriated funds.

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(ii) The Impoundment Control Act of 1974 (31 U.S.C. 1400 and following) shall apply to funds made available under section 167(b) and (e).

(2) After the Strategic Petroleum Reserve reaches a level of 500,000,000 barrels, the President shall immediately seek to undertake, and thereafter continue, petroleum products acquisition, transportation, and injection activities at a level sufficient to assure that the petroleum products in the Strategic Petroleum Reserve will be increased at an average annual rate of at least 300,000 barrels per day until the quantity of petroleum products stored within the Strategic Petroleum Reserve is at least 750,000,000 barrels.

The Conference Report on the bill enacted by the Congress advised as follows with respect to the fill of the SPR:

Section 4(a) amends section 160(c)(1) of EPCA to require the President to fill the SPR at an average annual rate of at least the minimum required fill rate until 500 million barrels are in storage. The minimum required fill rate will be determined in one of three ways.

Subparagraph (B) establishes the minimum required fill rate of 300,000 barrels per day. Under this subparagraph, the President may make a finding that compliance with the 300,000 barrel per day rate would not be in the national interest for good cause. For instance, the President may find that:

(i) compliance with such rate significantly impairs the ability of the United States to respond to a severe energy supply interruption;

(ii) compliance significantly impairs the ability of the United States to meet its obligations under the international energy program; or

(iii) compliance is inappropriate due to economic conditions affecting the general welfare.

If he makes such a finding and transmits it to Congress, accompanied by a statement of the facts upon which the finding is based, the minimum required fill rate shall be 220,000 barrels per day, as required by subparagraph (C).

Subparagraph (D) establishes the minimum required fill rate that would be in effect where funds are available in any given fiscal year after fiscal year 1982 to achieve an average annual fill rate higher than the minimum required fill rate in effect under subparagraph (C). In such cases,

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> the minimum required fill rate shall be the highest practicable fill rate achievable subject to the availability of appropriated funds.
>
> Appropriation Acts will necessarily govern the availability of funds. The purpose of subparagraph (D) is to express the policy that the President shall fill the SPR at the highest practicable fill rate achievable subject to the availability of funds. (H.R. Rep. 97-663 at 12)

During House floor action on the Conference Report, Chairman Philip R. Sharp of the Subcommittee on Fossil and Synthetic Fuels, House Committee on Energy and Commerce, described the bill as requiring that, after a Presidential finding not to fill at the 300,000 b/d level, the SPR be filled at a rate of at least 220,000 b/d "unless funds available through the appropriations process make it practicable to achieve a higher fill rate." 128 Cong. Rec. H. 4921 (July 30, 1982).

The statement of Chairman James A. McClure of the Senate Committee on Energy and Natural Resources said that after the Presidential finding, "the minimum required fill rate would be either 220,000 barrels per day, or, if funds are available to achieve a higher rate, the highest practicable fill rate achievable with available funds." Senator McClure's statement added, "Thus, appropriations acts will necessarily govern the availability of funds." 128 Cong. Rec. S. 9481, 9485-86 (July 30, 1982).

Senator Henry M. Jackson, ranking Minority Member of the Senate Energy and Natural Resources Committee, expressly noted that the statutory fill mandate ceased to be applicable, to the extent that available funds were deferred or rescinded pursuant to the Impoundment Control Act, 2 U.S.C. §681 et. seq. 1/ 128 Cong. Rec. S.9488 (July 30, 1982).

On November 4, 1983, the Department of Interior and Related Agencies Appropriation Act for Fiscal Year 1984 (Pub. L. No. 98-146) was enacted, providing for SPR fill as follows:

1/ Subsequently, the Comptroller General reported a deferral of that portion of SPR budget authority which the General Accounting Office estimated would not be used, based on then-existing Executive Branch plans to fill the SPR. Comp. Gen. B-209328, May 5, 1983.

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SPR Petroleum Account

The aggregate amount that may be obligated under section 167 of the Energy Policy and Conservation Act of 1975 (Public Law 94-163), as amended by the Omnibus Budget Reconciliation Act of 1981 (Public Law 97-35), for the acquisition and transportation of petroleum, and for other necessary expenses, is $650,000,000, in addition to authority provided in fiscal years 1982 and 1983, to remain available until expended: Provided, That the minimum required fill rate during fiscal year 1984 shall be not less than 186,000 barrels per day.

The fiscal year 1985 joint resolution providing for continuing appropriations (Pub. L. No. 98-473, October 12, 1984) provided:

SPR Petroleum Account

The aggregate amount that may be obligated under section 167 of the Energy Policy and Conservation Act of 1975 (Public Law 94-163), as amended by the Omnibus Budget Reconciliation Act of 1981 (Public Law 97-35), for the acquisition and transportation of petroleum, and for other necessary expenses, is $2,049,550,000, in addition to authority provided in fiscal years 1982, 1983, and 1984, to remain available until expended: Provided, That the minimum required fill rate during fiscal year 1985 shall be not less 159,000 barrels per day.

For fiscal year 1986, no new appropriations for oil acquisition were enacted; however, the Supplemental Appropriations Act for Fiscal Year 1985 (Pub. L. No. 99-88, August 15, 1985) overturned a proposed deferral of $290 million in SPR oil acquisition funds, thereby providing the Executive Branch with sufficient appropriations to fill the SPR to 500 MMB. The Act also amended the NPR shut-in provision contained in EPCA §160(d), to add a third exception, permitting NPR oil from Elk Hills to be sold even though the SPR had not reached 500 MMB, or was not being filled at 100,000 b/d, if "the fill rate is sufficient to attain a level of 500,000,000 barrels by the end of the fiscal year during which the fill rate falls below" 100,000 b/d. 2/

Finally, the Consolidated Omnibus Budget Reconciliation Act of 1985 (Pub. L. No. 99-272), added to §160(c) the following paragraph:

2/ In fact, the SPR has reached a level of 500 MMB.

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> (3) Notwithstanding paragraph (2), beginning in fiscal year 1986 and continuing through fiscal years 1987 and 1988 until the quantity of crude oil in storage within the Reserve is at least 527,000,000 barrels, the President shall carry out petroleum acquisition, transportation, and injection activities at a level sufficient to assure a minimum average annual fill-rate of at least 35,000 barrels per day in addition to any petroleum products acquired for the Reserve to replace petroleum products withdrawn from the Reserve as a result of a test drawdown and distribution.

In addition, it amended section 160(d) so as to compel shut-in of Naval Petroleum Reserve No. 1 at Elk Hills, California, unless either 527 MMB of crude oil are stored in the SPR, or SPR fill is proceeding during fiscal years 1986-88 at a minimum annual average rate of 35,000 b/d (in addition to amounts acquired to replace oil sold in a test drawdown).

Conclusion

In June 1978, when SPR Plan Amendment No. 2 set the 750 MMB and one billion barrel storage goals, the SPR contained only a very small fraction of the 250 MMB which were supposed to be in storage by that time. The SPR similarly fell far short of achieving the 500 MMB 1980 oil storage goal which had been established in the SPR Plan. Indeed, as of 1980 SPR fill had halted altogether. Yet at no time was the SPR Plan's storage schedule amended downward.

Commencing in 1980 and continuing into 1986, the Congress enacted legislation intended to specify the rate of fill and thus, in practical effect, the SPR's oil storage schedule. The oil fill requirements which the Congress imposed were well below those implied by the outdated and essentially moribund storage schedule contained in the SPR Plan. In our opinion, the numerous Congressional enactments concerning SPR oil storage superseded EPCA §154(c)(1) and (e)(6) and caused the storage schedule contained in the SPR Plan to be without legal effect.

The various Congressionally imposed fill requirements could not have been overridden by amendments to the SPR Plan. Thus these legislative mandates have been directly contradictory to the original statutory scheme of the EPCA, under which the Executive Branch could effectuate adjustments in the SPR's oil storage goals through SPR Plan amendments. While implied legislative repeals are not favored, the Supreme Court has held that an earlier statute must yield to a later one to the extent it supplants the earlier statutory scheme, District of Columbia v. Tynan, 78 U.S. 88 (1870), District of Columbia v. Hutton, 143 U.S. 60 (1892), and in our view the SPR fill rate requirements enacted by the Congress since 1980 succeed the EPCA's provisions on how those requirements would be determined.

We conclude that it is not necessary for the SPR Plan to be amended in order for the Executive Branch to propose SPR oil storage goals. Moreover, to the extent that the SPR Plan is intended to inform Congress of plans for SPR oil fill as distinguished from making legally effective changes in a fill schedule, it is clear that Congress now has chosen the appropriations process as the preferred vehicle. Repeatedly, the Congress has acted on SPR fill rate legislation in response to the President's budget, in the absence of any proposed SPR Plan amendment. We believe that Executive Branch submittals to the Congress in the budget process can satisfy the obligation to keep Congress informed of Administration proposals for SPR oil storage.

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Mr. SHARP. Thank you very much, Mr. Bauer. The Chair will now recognize members for 5 minutes of questioning. The Chair recognizes itself.

Mr. Bauer, you alluded to the fact that if you think there is a need for legislation you will let us know. Are you not already convinced that being required to produce at maximum efficient rate dramatically reduces your flexibility? Or, do you believe that you can more effectively protect the taxpayer without that flexibility?

Mr. BAUER. Well, Mr. Chairman, we were producing at what we will call the maximum efficient rate of production, but also in reviewing the statute it says, that the Secretary may apply sound engineering judgments.

If we look at two reservoirs, Main Body B and 26-R, those two rate-sensitive reservoirs I believe provide about 60 percent of the production that comes out of the field. By applying the statutory definition of sound engineering practices, we adjusted to a different MER production rate, which reduced the amount of oil from those two reservoirs I might say at this time as I have mentioned, we went out for engineering studies. We went to three contractors, who had the available data base Mr. Chairman, after looking at our new rate of production in accordance with sound engineering practices, the results of Babson & Shepard, Gruey Associates and Evans, Carey, & Crozier for those two reservoirs, are very close to the rate that we have selected.

So, what I am saying is on the production side of it, I think there is the flexibility within the statute at this time.

Relative to the petroleum sales, I believe there is also sufficient flexibility. We have developed about five different sales options that we are looking at this time. We have had dialog with our existing customers concerning these options.

What we are looking at first of all are the terms, conditions, the length of the contract, as well as methodology for pricing oil. The options we are looking at, include a fixed price for 60 days; fixed price with an economic adjustment, based on the spot price of crude oil on a percentage or dollar basis; a market basket of refined products approach; and others which are dependent upon different crude oil markets.

One other point. We put out a Federal Register notice soliciting the public's comments. Those comments are due back on the 16th of this month. At this time, the task force, made up of people in procurement and general counsel and the program office, is looking at these opitions. We will be going to the Secretary before the next bidding practice, with a procurement methodology that is responsive to market changes and changing conditions.

Mr. SHARP. Mr. Bauer, in February bids were accepted, which had in them up to $7 discount per barrel off the posted price. Am I correct?

Mr. BAUER. You are correct, Mr. Chairman.

Mr. SHARP. Did anyone at that time raise questions as to whether you ought to be accepting these bids—even though the market hadn't taken its full nosedive at that point? Wouldn't these high discounts signal someone that you are likely to be getting less than the fair price?

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Mr. BAUER. When those bids were received—I believe it was January 27—the Department looked at those bids, and there were several factors that were considered at that time. I will admit to you now in hindsight that we probably should have looked at it differently, but at that time there were five or six things that the department considered.

First of all, a very high volume of bids was received. I think the bids were for about 2½ times the amount of oil that we were selling.

Second, in looking at the discounts and looking behind what the bidders had in their minds, we came to the conclusion that the bids were probably rational and understandable at that time. The bidders thought that the spot market would fall over the 6 month period, and that the posted price would remain above the falling spot market price.

Third, on the day of the bid opening, the base price for Elk Hills oil exceeded the spot market price even if we applied the $4.40 discount. Then we were faced with another problem—if we recompete it, what do we do? We had the fact that we were producing. We had the fact that we have about a 3-day storage capacity, and we asked ourselves do we have any assurance that we would get a better outcome if we recompete? Or reissue? And we came to the conclusion that we had no such assurances, and so given the facts at that time, a decision was made for accepting those bids, Mr. Chairman.

Mr. SHARP. Your average discount was $4.40, but you did have some that went as high as $6.98, didn't you?

Mr. BAUER. There were some, Mr. Chairman, that had bid discounts up to around $12.68. Of course, they didn't get oil because we cut off awards at the point where they equalled the 82,000 barrels that we were selling.

Mr. SHARP. Is that correct, Captain?

Mr. RUMBOLD. Yes, sir, that is correct.

Mr. BAUER. So, there were very large discounts bid even above the average of $4.40 per barrel of oil for awarded contracts.

Mr. SHARP. In terms of who got a contract and got oil, you accepted some as high as $6.98 didn't you?

Mr. BAUER. Yes, we did, Mr. Chairman.

Mr. SWIFT. I guess you just ranked them down the list, and then draw a line. Is that the deal with the volume?

Mr. BAUER. You award from the smallest discount in order of bid price. However, after those bids are in, there are two things that happen. One, by statute, is the 30 day review by the Department of Justice for an antitrust determination; No. 2 there is the establishing of a performance bond in the form of a letter of credit.

At that point, you award to whomever bid the highest bonus or smallest discount, and keep going up. The subsequent awards are increasing in value of discount. When you get to the 82,000 barrels of oil per day that you are selling, you cutoff.

Mr. SHARP. The point being you just cut it off at the volume you had to sell; you didn't even—I mean, you were arguing earlier that the $4.40 didn't seem unreasonable at that time, but didn't $6.98 seem unreasonable to keep going down the list is the point I am making.

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Shouldn't somebody have been raising questions up the line of the chain of command?

Mr. BAUER. I agree with you, Mr. Chairman. What we did was array the discounts and cut off the bids at 82,000 barrels. The average discount of $4.40 was computed then we went back to look at the market on the day of opening, the spot market price and the posted prices. I agree with you. In hindsight, $6.00 plus for a discount seems unreasonable but we had a basis for accepting the bids at that time.

Mr. SHARP. My time has expired for this round. Let me go to my colleague from California, Mr. Dannemeyer.

Mr. DANNEMEYER. When is the next scheduled bid solicitation to take place?

Mr. BAUER. Mr. Dannemeyer, in accordance with the 90-day schedule, which is giving the bidders 30 days, the Department of Justice 30 days, and then 30 days for establishment of letter of credit and scheduling deliveries, I think we will have to be out by July 15 for deliveries beginning October 1.

Now, the only point to make, Mr. Dannemeyer, at this time we have not finalized the new sales process. We are currently on a 6 month contract, April to October, and the task force hasn't finished its report.

We are looking at terms, and by that I mean——

Mr. DANNEMEYER. When do you make the first step for this July 15 date you mentioned?

Mr. BAUER. July 15 will be the date of issuance of the invitation for bid.

Mr. DANNEMEYER. I see. But you are saying that you might be revising what procedure you will be following, is that right?

Mr. BAUER. Rest assured, Mr. Dannemeyer, we have looked at the past system we used, and we are coming up, I am almost certain, with a different sales methodology.

Mr. DANNEMEYER. There are some tanks that DOE owns in this facility aren't there, really?

Mr. BAUER. Yes, Mr. Dannemeyer.

Mr. DANNEMEYER. Did you recently try to sell those tanks?

Mr. BAUER. I am going to defer that to Captain Rumbold.

Mr. RUMBOLD. The tanks I believe that you are referring to, sir, are not the large storage tanks. They are other pressure vessels for natural gas liquids that we had that we tried to sell. There were 17 of those. They are not hooked up to any sort of system at all, sir.

Mr. DANNEMEYER. Could they be used for storage?

Mr. RUMBOLD. They could be, but they are low volume, considering the amount of volume that we do sell, and they would require a considerable amount of effort to hook them into the system, sir.

Mr. DANNEMEYER. I think at this time you are thinking about leasing those tanks, are you?

Mr. RUMBOLD. That is still an option to us, yes, sir.

Mr. DANNEMEYER. When a buyer takes delivery of oil from the field, a successful bidder, how do they move it? By tank truck, by pipeline, or how?

Mr. RUMBOLD. The vast majority of the crude oil as it leaves the oil field, sir, is by pipeline. We do have a little bit that goes out by truck, but the vast majority goes out by pipeline.

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Mr. DANNEMEYER. Pipeline—did I hear right. There are 13 buyers right now of the oil?

Mr. RUMBOLD. That is correct. We have about 15 buyers right now.

Mr. DANNEMEYER. And how many pipelines are taking the oil out?

Mr. RUMBOLD. There are several pipelines that go out. Chevron pipeline takes some of the crude, plus there is a Four Corners pipeline that leaves our facility, and the refiners, or our buyers, will nominate their requirements into the pipeline system.

So, essentially all of the crude that is going south goes through the one pipeline.

Mr. DANNEMEYER. South to where?

Mr. RUMBOLD. To the LA basin—primarily into the LA basin.

Mr. DANNEMEYER. And the bidder of the oil, do they control this pipeline?

Mr. RUMBOLD. No, sir.

Mr. DANNEMEYER. Who owns the pipeline?

Mr. RUMBOLD. That is the Four Corners pipeline, sir.

Mr. DANNEMEYER. Who owns that?

Mr. RUMBOLD. I believe that is under ARCO.

Mr. DANNEMEYER. Is ARCO one of the buyers?

Mr. BAUER. They are not.

Mr. DANNEMEYER. What does the buyer do? Make a deal with ARCO to move the oil through the pipeline?

Mr. BAUER. It is my understanding, Mr. Dannemeyer, upon selection of a contractor and his establishment of credit, they schedule deliveries. That purchaser establishes a delivery schedule, which is agreed upon by the pipelines. It also has to be agreed upon with us, because we are producing, and number two, the availability of that pipeline, and that is a common carrier pipeline so they have to sit down and work out the deal.

It is a commitment to accept the oil from us. That is what that bidder does. He says I am buying oil from the Department of Energy, and you have a pipeline and I want to schedule delivery of that oil.

Mr. DANNEMEYER. And the pipeline is required to carry it?

Mr. BAUER. That is the arrangement that the successful bidder makes with the common carrier pipeline, yes.

Mr. DANNEMEYER. Thank you, Mr. Chairman.

Mr. SHARP. The distinguished gentleman from New York, Mr. Stratton is recognized for 5 minutes.

Mr. STRATTON. Thank you, Mr. Chairman. I was the chairman of the Investigations Subcommittee in the House Armed Services Committee when we looked into this whole matter of Elk Hills and Teapot Dome, back in 1974 and 1976, and listening to the witness, Mr. Bauer, since I came in talking about the taxpayers, and getting the best deal for the taxpayers, it is my understanding that the reason that we are concerned about Elk Hills is that it is a naval petroleum reserve, and we are not concerned about who is going to buy what.

The people that we are concerned about are the swabbers, who are out there on the ships in the event that we run out of oil. We don't believe that we are running out of oil at the present time. I

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understand that there is a glut, but the point is that Elk Hills is something that has been reserved in the event, God help us, that we don't have any oil or any uranium to propel the ships of the U.S. Navy. It seems to me that we ought not to be dickering over the prices.

We ought to be preserving this, because it may be needed. Nothing has been put into the strategic reserve for a long, long time. In fact, the law provides that the President may direct the Secretary to place that petroleum in the strategic petroleum reserve. We are not trying to make money, I would hope, from Elk Hills.

What we are trying to do is see that there is going to be adequate fuel for the Navy, regardless of what may transpire in the Middle East or anywhere else.

It seems to me that appears to be overlooked by the Department of Energy.

Mr. BAUER. I will make a few comments, and then have Mr. Furiga amplify them.

First of all, out of the amount of Elk Hills oil that is produced, there are about 16,000 plus barrels of oil that goes to DOD under an agreement that we have today.

Number two, there has been oil moved in the past—I think it was like a million barrels—down to SPR some years ago. I understand what you are saying, but on the other hand, the President made the determination to continue production at the maximum efficiency rate in accordance with the statute, and the Secretary is authorized to sell that oil openly and competitively.

And, so, what we have available to us are two options. To continue to produce, or to shutin. Faced with the fact that some of the reservoirs are rate-sensitive, and we are injecting water and gas into those, one has to be very careful on what one does to that reserve so that he does not affect ultimate recovery of the 700 million plus barrels that are in the ground.

I am going to ask Mr. Furiga to talk about the transportation issue of moving Elk Hills oil to SPR.

Mr. FURIGA. A few things, Mr. Stratton. First of all, we have been adding oil to the strategic petroleum reserve since 1981 in pretty significant quantities.

Mr. STRATTON. Since what? 1901?

Mr. FURIGA. 1981. As a matter of fact——

Mr. STRATTON. As soon as you created the strategic reserve, that was what was going to happen to it. It was going to be sent over there in some way.

As I recall, there wasn't any pipeline; but in spite of that, the idea was to get the Elk Hills oil into the strategic reserve.

Mr. FURIGA. I am not aware of that concept, Mr. Stratton. I have been with the reserve since 1977. As I was saying, on June 1, we reached 500 million barrels in the strategic petroleum reserve.

As Mr. Bauer said, we have almost a million barrels of naval petroleum reserve oil that we move directly through the pipeline system from Elk Hills to one of our storage sites in Louisiana, West Hackberry. We brought that across country very slowly at 10,000 barrels a day.

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Today, that pipeline system which starts with the Four Corners, goes into the Tex-Mex pipeline and a few other local pipelines to get over to Louisiana, is at capacity.

We checked very recently, and as a matter of fact, they are prorating their customers at 33⅓ percent.

In other words, if a customer nominates 30,000 barrels for shipment through the pipeline, he gets 10,000 barrels out the other end. So, that pipeline system today is pretty much at capacity.

Now, when the All-American pipeline is completed, and we understand that is scheduled for completion later on this year, that will add significant west-east capacity for moving crude oil.

The strategic petroleum reserve, we feel, is better equipped and situated to satisfy not only DOD needs, but the domestic needs since we can remove oil from the SPR at about 3 million barrels a day, and as I think has been said, Elk Hills produces something like a hundred thousand barrels a day, and there aren't too many ways of getting that oil out of California.

Most of the Elk Hills crude is refined in California. The SPR can reach a broader range of refiners.

Mr. STRATTON. How many barrels can you extract from that per hour, or day, or whatever?

Mr. FURIGA. From the strategic petroleum reserve?

Mr. STRATTON. Yes.

Mr. FURIGA. We are in salt caverns, and we can remove oil from our caverns at 3 million barrels a day. We have five storage sites in the gulf coast, and that is our combined drawdown rate.

Mr. STRATTON. Well, the thing that bothers me is that along with the strategic materials stockpile, which the Armed Services Committee is also charged with protecting, we seem to be more interested in getting the money for oil or tin or what have you, platinum, rather than preserving it for an emergency.

This is the thing that has concerned us, and it is my understanding that you have recently gone down to the lower scale of the maximum efficient rate, which is what I think the committee intended should be done.

Mr. BAUER. Mr. Chairman, just one comment that you made a few moments ago, talking about the strategic critical materials, from the sale of the crude oil out at Elk Hills in accordance with the statutes, over half a billion dollars has been deposited in the Treasury for strategic critical materials to be utilized by GSA at the request of FEMA. That money is currently in the Treasury, and to my knowledge, none has been obligated.

Mr. SHARP. The time of the gentleman has expired. The gentleman from Texas, Mr. Fields, wants to be recognized, and then we will have to take a break for the vote.

Mr. FIELDS. Thank you, Mr. Chairman, and I will do my best to be very brief. Mr. Rumbold, I am not familiar with how Elk Hills is used beside the mineral extraction. What are their purposes—is that area used for?

Mr. RUMBOLD. The Elk Hills Naval Petroleum Reserve is dedicated to the production of petroleum. We have produced crude oil, natural gas, and natural gas liquid products.

Mr. FIELDS. So, there is no surface usage?

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Mr. RUMBOLD. No, sir. We are the only ones on that, ourselves, and our partner, Chevron.

Mr. FIELDS. Mr. Bauer, that leads me to the question: Does the administration still favor privatizing Elk Hills, and if so, do you know where are we in that process?

Mr. BAUER. Mr. Fields, lately I have been using the words, "asset divestiture," because I think anybody who is interested in that would consider it an asset.

We have been requested to provide some drafting services to the Congress on legislation for asset divestiture. We have taken a look at a calculation of the value of the asset, and this subcommittee also had, I believe, GAO recently take a look at the value of the asset.

I think the point right now between DOE and GAO, is what does one use as a discount rate? We are using the OMB circular A-94, and we are using something like a 14-percent discount, and I believe that the GAO is recommending, or had used a rate of something like 7½ percent, but that is in the calculation of the value of the asset.

The bottom line turns out to be not only is it a dollar and cents issue, but it is also an issue of the U.S. Government is role in operating a commercial field, in the production of oil and natural gas, and its byproducts, propane and butane and all that, operating that in the marketplace. There is nobody better than the marketplace to know how to do that.

I think, maybe, if the marketplace had been out there operating it when oil came up for sale on the 1st of April, we would have a different study, because there are posted prices, and those aren't what people pay.

What actual contract prices are, that is confidential information, so here the U.S. Government is operating a commercial business and really we shouldn't be in that.

Mr. FIELDS. I agree with you. Mr. Chairman, thank you for allowing me to ask questions.

Mr. SHARP. Thank you. We are going to have to take a recess. There are just a few minutes left to vote on the House floor. Gentlemen, if you can bear with us, we have a couple of more questions for you. Mr. Stratton may have a couple, and then we will go to our second panel.

Mr. BAUER. With all due respect.

Mr. SHARP. We will stand in recess for 10 minutes.

[Brief recess.]

Mr. SHARP. The subcommittee will come to order. The Chair now recognizes himself for questions.

Mr. Bauer, has the Department considered backing away from those contracts that it has now that clearly in the current marketplace are a loss from the Government's point of view, and trying to simply re-bid them like on July 1, or something of that sort?

Mr. BAUER. Mr. Chairman, the issue that was facing us, and we did face—was with your permission, look at the question this way. Could I cancel all the contracts, and reissue the solicitation?

Mr. SHARP. Yes.

Mr. BAUER. And to that, I have several points. The first one is, can I terminate. Those contracts today have a provision in them

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for termination for convenience without any liability. So can I terminate the contracts today? The answer is, yes.

But there are several factors that I think need to be looked at. First of all, termination of those contracts, in my opinion, would probably in all probability alienate our current customer base by terminating those prematurely in the hopes or the prospect of getting a higher price.

Mr. SHARP. You mean you think you will lose your customer base, the people that have bid on this, if you terminated those contracts. Is that what you are saying?

Mr. BAUER. Yes, Mr. Chairman. Because I think what would happen is this customer base, in essence, is going to be bidding against itself. Because the people that purchase the oil are the ones that have been purchasing, you know, for a long time.

Mr. SHARP. I am told over and over and over by the California delegation: You must pump this field, because if you don't pump this field, refiners won't have the light crude to mix with the heavier. There is a desperate need for this light oil that comes from the naval petroleum reserve.

Have I got the message wrong from these folks?

Mr. BAUER. Well, we get that message, and then we get the other one that says you would really help the other producers if you would cut back, because what you are doing is putting out a guaranteed amount of oil into the market.

So, if you cut back, that will cut back on the glut that exists in the California area, and I think this is representative of the things that faced us since January. A lot of different stories, a lot of different perspectives.

Mr. SHARP. I realize the law requires you now to produce at MER. When I asked you if we should get rid of the MER requirements you said you are still waiting to decide that. This is the kind of flexibility that we are talking about.

Why couldn't you do this?

Mr. BAUER. I think that if I terminated the contracts today, and reissued, that another thing would happen, and that is—well, it is a good possibility. That we would be in litigation.

I think courts have upheld recently, courts and appeals courts, that says that cases of termination for convenience, because that is what I would have to invoke, may not be upheld if something is done in bad faith or for an arbitrary purpose, or in a capricious manner, so it conceivably could end up in litigation with claims, and the other point——

Mr. SHARP. Did the Department litigate when one of its previous bidders terminated a contract on the same basis?

Mr. BAUER. I believe, Mr. Chairman, that was back in about 1979 or 1980. I think there were two or three purchasers of the oil terminated, and at that time there was a right to terminate on the part of either party, the U.S. Government, as well as the person buying the oil.

So, they terminated at that time—I think it was for several reasons, and one was a financial situation, and another one just couldn't use it or refine it or something.

I could provide that for the record. The rationale for those terminations.

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[The information follows:]

In 1980, Elk Hills crude oil contracts contained a provision allowing either party to terminate the contract with 90-days' notice. The contract did not expressly require a justification to do so. Based upon that clause, Phllips Petroleum and Oasis Petro Energy Corporation terminated their entire contracts for convenience, and Pacific Refining Company partially terminated its contract. Subsequent contracts did not allow purchasers to terminate contracts for their convenience.

Mr. SHARP. One thing I wonder is just how serious those threats really are, and maybe the Department has assessed them.

Some of those customers you are selling to, I am told have terminated contracts. Perhaps the terms of the contract are different, but I am not sure they are.

Did you look at that question? Did some of those refiners that you sell to cancel their contracts with other producers because they didn't like the terms of what was happening in the oil prices?

Mr. BAUER. I have not looked at that. If it has happened, or if any of the people on the task force working on past activities and new methodology, if there is any data—and we are having discussions now with the refiners and the producers and our current customer base—if there is any data that makes that point, I will provide it for the record, but not to my knowledge.

[The following information was received:]

The terms of the contracts in 1980, did not require the contractors to explain why they exercised their rights to terminate the contracts.

Mr. BAUER. The other thing is if I canceled and resolicited to generate more revenue, it is my understanding that the average price of the new contracts would have to be better than the average price of the current contracts that I have today, and I have no assurance that that is going to happen either.

Mr. SHARP. Are you saying that if you were to cancel the bid, you would have to cancel all of them?

You don't have a choice to cancel those that seem to be more outrageous than others is what you are saying.

Mr. BAUER. Well, that leads to another point which is, can I cancel the highest discount, which was an earlier point that you had made, Mr. Chairman, about somebody up at $6; and yes, there again, one can terminate for convenience without liability, and at that point, one would have to then prorate or resell that oil.

You prorate it on the basis that the other people buying the oil will accept it, and if they can't, then I have to resell it, which puts me into a 90-day cycle, and it all depends on what that person is buying, how long I can store that oil.

But also that may get me into the courts, because I am picking on this guy. He bid openly and competitively in the marketplace. I believe there is another provision, Mr. Chairman, and if it is wrong, with your permission, I will correct the record. I think there is only 15 percent of a contract quantity that can be prorated to the other people that are buying the oil.

This all, I think, comes down to a thing of concern to me and I hope the committee shares it, and it is doing things like this—well, it has been on my mind. Doing things, such as canceling and resoliciting, going to the guy who has the highest discount, can potentially undermine the integrity of the Government as a reliable

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partner, and have a long-range, negative impact on our ability to sell the oil in the future.

How much value one puts on that concern—I have a lot of concern because of the other programs that we are administering. I testified before you in front of fossil R&D on this business of terminating contracts because of changed policy, terminating contracts because of a deferral or something.

I am concerned about our respect in the marketplace.

Mr. SHARP. I can understand that concern. I am also concerned about our Government being taken as a patsy, and anybody has any right to hit it up for anything they want, and take advantage of it, and contracts with the Government are argued to be sanctified, but contracts with a fellow refiner or producer or somebody else, why that is another question, and I realize that works in reverse, too.

You can argue both sides of that kind of thing. Let me ask you, do those contracts have any penalty terms if you did not terminate for purpose of convenience? Some kinds of contracts in the private marketplace will say there is a penalty.

Mr. BAUER. It is without liability.

Mr. SHARP. I understand that term is there. Is there any other condition by which you can terminate other than—is the one provision previously mentioned in the contract that relates to termination?

Mr. BAUER. No other provision, other than termination for default. The contractor can default on us for various reasons, then we will be left with that oil since we are still producing. If he took that action, we would have the option to prorate among the balance of the people taking the oil.

So, anything we have now we could terminate for convenience, with no liability, or the contractor could come to us for some reason and default on us. That is the only——

Mr. SHARP. Would you go back and explain to me the issue you raised a moment ago about the restriction on pro rata? I didn't quite understand it.

Mr. BAUER. It says that if we canceled the highest discount person, we would prorate the oil that he was purchasing on a weekly basis among the balance of the customers, or resell.

The second thing is that only 15 percent of his contract quantity can be prorated among the balance of the other contractors.

James Tillman, of Procurement Operations, is going to clarify that point.

Mr. TILLMAN. Mr. Sharp, the way the contracts work is that we have contracts with a number of particular bidders. If one bidder, for some reason, were to default. and we chose to prorate that oil among the other contracts, the maximum amount that we could prorate to any one individual contractor would be up to 15 percent of whatever volume he was buying from us on a particular contract.

Mr. SHARP. So, what you are saying is, you are not in a position to simply terminate 30 percent of the oil and rebid 30 percent of the oil, and everybody that is in the system could have a chance to bid on that 30 percent?

Mr. TILLMAN. That is correct.

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Mr. SHARP. And what prevents you from doing that? Is that in the terms of the contracts with other folks, or is that just simply your procurement regs?

Mr. BAUER. It is under the terms of the contract.

Mr. TILLMAN. The amount that we were able to terminate under the proration scenario that we talked about, we would be limited to prorating 15 percent of the total volume that we had on the remaining contracts.

In other words, if we terminated those contracts, we could not prorate more than 15 percent of the total volume, and that——

Mr. SHARP. I am talking about total new sale of that 30 percent we just terminated in the hypothetical example.

Mr. BAUER. I could resell.

Mr. SHARP. Up to 15 percent of it you could prorate around to the previous bidders is what you are saying.

Mr. BAUER. Yes.

Mr. SHARP. If July 1 you chose to open up new bids or—terminate 30 percent of the contracts and tried to resell it, obviously it runs afoul of the principles you were articulating.

Mr. BAUER. I can prorate and I can resell, and go back out and solicit on an emergency basis bids for buying that oil. We have that option, Mr. Chairman.

Mr. SHARP. The Chair will recognize the gentleman from New York, Mr. Stratton.

Mr. STRATTON. I am advised that the All-American Pipeline would begin accepting oil in July of this year, initially at 15,000 barrels daily and 50,000 to 60,000 barrels daily later for delivery in the strategic petroleum reserve in Texas.

If you are faced with the same bid situation in July that you have encountered earlier this year, does the Department of Energy intend to use that pipeline for moving oil to the SPR in Texas?

Mr. BAUER. I am going to let Mr. Furiga answer that, since we are undergoing all of these activities on the Naval Petroleum Reserve. He is also in charge of the strategic petroleum reserve, and I've asked him to address the transportation issues.

Mr. FURIGA. Mr. Stratton, we met with the All-American Pipeline Co. last week. According to what they said at that meeting, it's going to take them about 4 months just to pack that pipeline. They aren't looking for operation until the first part of next year.

That pipeline when in operation, as I've stated previously, will provide a significant capability to move oil west to east. But, it's not now in operation.

We are also faced with the fact that the strategic petroleum reserve, when we reach 502 million barrels in early July, our policy is to go into a moratorium at that time and not fill the strategic petroleum reserve. So, a few things have to happen.

The policy on the moratorium would have to be revised, so the SPR would continue to be filled. And the All-American Pipeline would, in fact, have to be in operation. As I said, it's not in operation right now. And the projections——

Mr. STRATTON. Well, it wouldn't——

Mr. FURIGA [continuing]. According to the last——

Mr. STRATTON. It wouldn't be a bad place to store it, would it, in the pipeline?

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Mr. FURIGA. I don't think that is viable. That pipeline I believe primarily was built to move heavy California crude east.

The SPR stores light crude. And I don't think we would want to use the crude that they are going to use to pack that pipeline.

We have looked at pipeline storage in the past for the SPR. It's not viable. The salt caverns are the best way to go.

Mr. STRATTON. My experts tell me that it can be done. And you seem to be awfully reluctant to put anything into any storage situation.

You might even have to shut down Elk Hills. The Armed Services Committee has had to fight this battle over a long period of time, and everybody wants to grab from the Naval Petroleum Reserve.

And you guys want to sell it so that it will look better on the books and reduce the national deficit. But, we might never be able to recover this.

I think you ought to take another look at that. I would like to have you talk to Mr. Price why it's impossible for you to store it in the All-American Pipeline.

Mr. BAUER. Mr. Stratton, first of all, I will be glad to talk to the members of your staff.

No. 2, it's my understanding that they said that the line will not be operational, fully operational, to accept oil until January 1987.

And, point three, we have carefully maintained control of the oil, the sweet and the sour, that we have bought for the strategic petroleum reserve. And at the time that we did a recent sale, we were able to identify to potential buyers what quality of oil they were going to get by API standards.

If, in fact, we did comingle the good Elk Hills oil with other heavy crude oil, it would put a tremendous burden on us, on the other end of that pipeline, to do analysis to figure out what kind of oil we were getting and if we could comingle it with the sweet and sour that we are putting into various caverns in SPR.

But, Mr. Stratton, I do welcome the opportunity for my staff to meet with your staff and discuss the issue. Transportation of NPR oil to SPR has happened in the past, and in looking at the future it is not a closed door.

Mr. DANNEMEYER. I have a question, Mr. Chairman. We have talked about the oil from Elk Hills.

Tell us a little bit about the natural gas that is coming out of there. What method do you use to sell the natural gas that is produced as a part of the production?

Mr. RUMBOLD. Yes, sir. We sell that under the competitive bid process as well. We are producing somewhere around 400 million cubic feet per day and we are selling a good portion of it. The majority of our gas is reinjected in for reservoir pressure.

Mr. DANNEMEYER. The portion of gas that's being sold, are you offering that for sale every 6 months, similar to the oil?

Mr. RUMBOLD. It's on a 1-year contract, sir.

Mr. DANNEMEYER. 1-year contract?

Mr. RUMBOLD. Yes, sir.

Mr. DANNEMEYER. And what's the price we are getting on that natural gas right now?

Mr. RUMBOLD. The current price is $3.11 per million Btu.

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Mr. DANNEMEYER. That's the price that the Government will get for the year of this current contract.

When was that contract signed?

Mr. RUMBOLD. The current contract is going through September 1 or August 31. The new contract is out on the street right now for rebid effective September 1.

Mr. DANNEMEYER. The spot-market price for gas in California is what?

Mr. BAUER. I don't know that right now. I will be glad to provide it for you.

Mr. DANNEMEYER. It's about—well, I've heard reference it's about $1.70, is the spot-market price for natural gas?

Mr. BAUER. That's about right. The Great Plains Project, up there the spot-market price in North Dakota is a $1.89. That's about right.

Mr. DANNEMEYER. So, the Government today is realizing at least a benefit from the sale of the natural gas in the sense that the price we are getting is above the market?

Mr. BAUER. Yes, Mr. Dannemeyer.

Mr. DANNEMEYER. But, the oil is a story that makes us all want to shake our heads and look for a scapegoat. And I guess you are as good as any we can find right now.

Mr. BAUER. It started last August with the Great Plains, Mr. Dannemeyer, so life has been challenging but it has been an experience.

Mr. SHARP. Well, Mr. Bauer, we are not looking for scapegoats. We are just looking for a way not to lose $4 to $6 or $8 million in the next several months.

And I strongly urge you to reexamine that option of reopening those contracts. If you were the only folks doing it in the marketplace, I think you would have an excellent argument for why it shouldn't be done.

But that's not my impression. Others are playing by those same set of rules. And, we are taking a loss on this oil. And you are in the business here, have been put in the business, and we are all part of that business.

I think that we want to marshall all your resources. I know it's your commitment to marshall them as best you can. I hope you will seriously consider—you said in an emergency you could do it—cancelling the contracts.

We are selling some of that oil for $7 less than what other people are selling oil for around here at a time when everybody is selling for a lot less than they were just 6 or 8 months ago. And, obviously I know you don't like doing that. I know that's not your desire to do that.

I hope you are going to take every action that's available to you to stop doing it in the time that's left on those contracts.

Mr. BAUER. Mr. Chairman, I have taken, and I will continue to take, all of your remarks seriously. I share your concern.

And I can say that we have the task force made up of the people from the general counsel, Procurement and the Program Offices, looking into new sales methodology. And the suggestion you have made and reiterated several times to me, we are going to meet

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again this afternoon, will be on the agenda. And, I can assure you that it will.

And I assure you we will keep you informed as to our progress and our decisions.

Mr. SHARP. Thank you very much. I appreciate your help and Captain Rumbold and Mr. Furiga at this morning's hearing.

Thank you so much for being with us.

Mr. BAUER. Thank you very much, Mr. Chairman.

Mr. SHARP. We now have our second panel of witnesses, Mr. James Duffus, Associate Director of Resources, Community and Economic Development with the U.S. General Accounting Office; Mr. John T. Cameron, vice-president of Producing, Exploration and Land with Chevron U.S.A., Inc.; Mr. Stephen Berg-Hansen, California Independent Producers Association; Mr. Robert Redd, vice-president, Golden West Refining, speaking for the American Independent Refiners Association.

Gentlemen, welcome. I think you understand our process here. We will be happy to make your written statement a part of the record. We will be happy to hear your oral testimony at this time. Please summarize it and stay within about 5 minutes.

Mr. Duffus.

STATEMENTS OF JAMES DUFFUS III, ASSOCIATE DIRECTOR, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, GENERAL ACCOUNTING OFFICE; JOHN T. CAMERON, VICE PRESIDENT OF PRODUCING, EXPLORATION, AND LAND, CHEVRON U.S.A., INC.; STEPHEN BERG-HANSEN, EXECUTIVE VICE PRESIDENT, CALIFORNIA INDEPENDENT PRODUCERS ASSOCIATION; AND BOB REDD, VICE PRESIDENT, GOLDEN WEST REFINING CO., ON BEHALF OF THE AMERICAN INDEPENDENT REFINERS ASSOCIATION

Mr. DUFFUS. Thank you, Mr. Chairman. I will summarize my statement and submit my prepared statement for the record.

With me today is Cliff Gardner, who is the group director working in the area of naval petroleum reserves.

DOE sells nearly all of the Government's share of Elk Hills oil in the local California area under open competitive bidding procedures. Contracts are awarded for 6-month periods, but bidders are required to make offers to buy oil nearly 3 months in advance of the start of the contract period.

DOE uses an average of the highest three posted prices to establish a base price for the Elk Hills oil. Prospective buyers offer a bonus or discount to be applied against the base price for all deliveries accepted during the contract period.

Our May 9, 1986, report, which was done for you Mr. Chairman, noted that for the contract period, October 1, 1985, through April 1, 1986, the Department of Energy sold 86,000 barrels of oil per day at discounts ranging from 19.7 cents to $1.16 a barrel.

Posted prices remained relatively stable until early February 1986, although spot-market prices had been declining since December of 1985. DOE's sales prices also were fairly stable and were generally higher than spot prices in January and February.

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California posted prices dropped rapidly in February and March 1986 until they were closer to prevailing spot prices. Because of the small discounts, however, Elk Hills oil sales prices during this period closely tracked the posted and spot prices.

The differential between DOE's sales prices and posted prices changed drastically after the high discounts bid in January 1986 were applied to the April and May deliveries. Contracts with bid discounts as high as $6.98 per barrel had been awarded by the Department.

When these discounts were applied to the already reduced base prices, Elk Hills oil was sold for as little as $6.30 a barrel in April 1986. In May 1986, the oil was sold for $6.23 a barrel, the difference, according to DOE, was due to the quality of the oil being delivered.

The relatively large discounts from DOE's base oil prices will continue to apply to all deliveries through October 1, 1986.

Thank you, Mr. Chairman.

[Testimony resumes on p. 74.]

[The prepared statement of Mr. Duffus follows:]

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
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STATEMENT OF

JAMES DUFFUS III

ASSOCIATE DIRECTOR

RESOURCES, COMMUNITY, AND ECONOMIC

DEVELOPMENT DIVISION

BEFORE THE

SUBCOMMITTEE ON FOSSIL AND SYNTHETIC FUELS

HOUSE COMMITTEE ON ENERGY AND COMMERCE

AND THE

SUBCOMMITTEE ON INVESTIGATIONS

HOUSE COMMITTEE ON ARMED SERVICES

Mr. Chairman and members of the Subcommittees, we appreciate the opportunity to participate in this hearing and provide comments on the sales of crude oil by the Department of Energy (DOE) from the Elk Hills Naval Petroleum Reserve (NPR) located in central California. Specifically, you asked us to summarize the information contained in our May 9, 1986, fact sheet developed at your request.[1] Our fact sheet included sales data from October 1, 1985 through April 23, 1986. For the hearing today, we updated the sales data through May 1986.

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[1]Naval Petroleum Reserves: Sales Procedures and Prices Received for Elk Hills Oil (GAO/RCED-86-163FS, May 9, 1986).

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The Elk Hills NPR is the seventh largest domestic producing oil field in the United States. The federal government owns about 78 percent of the field and Chevron USA owns the remaining 22 percent. The Naval Petroleum Reserves Production Act of 1976 (Public law 94-258) authorized and directed that the Elk Hills field be explored and developed to its full economic and production potential and produced at its maximum efficient rate (MER) for 6 years. Continued production after that period was dependent on a presidential determination that it is in the national interest to do so. In October 1984 the President determined that production at MER should continue through April 5, 1988. From July 1976, when Elk Hills first started producing, through September 1985, nearly 474 million barrels of oil had been produced. Net revenues to the government from operating Elk Hills have totaled over $9 billion.

DOE sells its share of Elk Hills crude oil production under 6-month contracts on the open market by competitive bidding as provided for by the Naval Petroleum Reserves Production Act. The invitations for bid are sent out 3 months in advance of the contract period. Based on anticipated oil needs and a perception of where prices are likely to be during the contract period, prospective buyers submit bids specifying the quantity of oil to be purchased and the bonus or discount from DOE's base price that they are willing to pay.

DOE computes its base price for Elk Hills oil from Crude Oil Price Schedules sent to producers by the major oil companies operating in the central California area. These price schedules

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reflect the prices the companies are willing to pay for a specified oil quality and become the "posted" price for that oil until superceded by a subsequent offering. DOE establishes its base price for contract purposes by taking the average of the highest three posted prices. As the NPR oil is produced and delivered, the net price per barrel is determined by taking the DOE base price and adjusting it for the contract bonus or discount and the quality of the oil.

Our May 1986 report noted that during the period October 1, 1985, through April 1, 1986, DOE sold about 86,000 barrels of oil per day under its contracting procedures. The bids submitted by prospective buyers included discounts from DOE's base price that the buyers wanted applied to deliveries during the 6-month contract period. The contracts awarded by DOE for the 86,000 barrels per day contained discounts from DOE's base prices ranging from 19.7 cents to $1.16 per barrel.

From October 1, 1985, through February 5, 1986, posted oil prices remained fairly stable, ranging from $24.88 to $24.95 per barrel. Consequently, DOE's base prices and its net selling prices also remained fairly stable. By early February, the posted prices in California began to decline, reflecting the decrease in world spot market oil prices that had been occurring since December 1985. As a consequence, DOE's base price for NPR oil dropped from $23.51 on February 10, 1986, to $14.47 on April 3, 1986, with the actual sales price further reduced by the amount of the contractual discounts. However, because the discounts were relatively small--19.7 cents to $1.16 per barrel--these NPR oil

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sale prices were still generally comparable to the posted prices being offered by major oil companies in California for oil of comparable quality and were generally higher than prevailing spot market prices.

The difference between the NPR sales prices and the oil companies' posted prices markedly increased after April 1, 1986, when the new contract terms for the April 1 through October 1, 1986, period went into effect. In December 1985, DOE issued invitations to bid on purchases of 82,000 barrels of oil per day during the April to October period. Although the posted prices in central California had not yet reflected the decline in world oil prices, DOE officials said the uncertainty about future oil supplies and prices resulted in bidders specifying much larger discounts than were previously bid. For the 104 separate bid offers received, the discounts ranged from a low of $0.87 to a high of $12.58 per barrel for over 186,000 barrels of NPR oil.

DOE awarded 15 new contracts for the 6-month period, with the largest discount offer accepted amounting to $6.98. As the sales schedule in our report shows, these contract awards resulted in DOE selling Elk Hills oil in April 1986 for prices ranging from $6.30 to $11.27 per barrel.

As you requested, Mr. Chairman, we updated the NPR sales data through May 28, 1986. These data show that posted prices for April continued at the same level through May. We noted some small increases and decreases in DOE's base prices and the actual selling prices. DOE officials told us that these variations were

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due to oil quality adjustments on individual deliveries. A listing of the crude oil contract sales for April and May is attached to this statement.

Without amendments to, or cancellations of, the present contracts, Mr. Chairman, the relatively large discounts from DOE's base oil prices will continue to apply to all oil deliveries through October 1, 1986.

Mr. Chairman, this concludes my prepared statement. I will be happy to respond to any questions.

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ELK HILLS CRUDE OIL PRICES FOR DOE BILLINGS
MADE APRIL 8, 1986, THROUGH MAY 28, 1986

Company	Billing date	Barrels lifted[a]	DOE base price	Contract discount	Average price paid[b]
			(dollars per barrel)		
Alliance Oil and Refining Co.	4-09-86	6,550	$13.80	$6.98	$6.82
	4-16-86	5,853	13.32	6.98	6.34
	4-23-86	5,835	13.28	6.98	6.30
	5-01-86	6,696	13.23	6.98	6.25
	5-06-86	5,150	13.25	6.98	6.27
	5-13-86	5,898	13.29	6.98	6.31
	5-20-86	5,217	13.21	6.98	6.23
	5-23-86	2,195	13.21	6.98	6.23
	5-27-86	2,817	13.21	6.98	6.23
Beacon Oil Co.	4-09-86	7,711	13.80	6.949	6.85
	4-16-86	6,940	13.32	6.949	6.37
	4-23-86	6,868	13.28	6.949	6.33
	5-06-86	6,060	13.25	6.949	6.30
	5-13-86	6,940	13.29	6.949	6.34
	5-20-86	6,140	13.21	6.949	6.26
	5-23-86	2,543	13.21	6.949	6.26
	5-27-86	3,315	13.22	6.949	6.27
Bemico Corp.	4-08-86	7,340	13.80	5.79	8.01
	4-15-86	9,188	13.21	5.79	7.42
	4-22-86	8,803	13.19	5.79	7.40
	5-01-86	12,491	13.19	5.79	7.40
	5-05-86	4,952	13.15	5.79	7.36
	5-12-86	7,844	13.20	5.79	7.41
	5-19-86	8,470	13.15	5.79	7.36
	5-28-86	11,133	13.15	5.79	7.36
Caljet, Inc.	4-10-86	12,494	13.70	4.985[c]	8.72
	4-16-86	14,684	13.20	4.985[c]	8.22
	4-23-86	13,205	13.17	4.985[c]	8.18
	5-01-86	18,320	13.19	4.985[c]	8.20
	5-06-86	15,733	13.45	4.985[c]	8.46
	5-13-86	21,202	13.84	4.985[c]	8.85
	5-20-86	20,649	13.81	4.985[c]	8.82
	5-27-86	18,201	13.82	4.985[c]	8.83
Champlin Petroleum Co.	4-08-86	86,662	13.80	4.825[c]	8.97
	4-15-86	108,476	13.21	4.825[c]	8.38
	4-22-86	103,939	13.19	4.825[c]	8.37
	5-01-86	147,483	13.19	4.825[c]	8.36
	5-05-86	58,475	13.16	4.825[c]	8.33
	5-12-86	92,622	13.21	4.825[c]	8.38
	5-19-86	100,018	13.15	4.825[c]	8.32
	5-28-86	131,456	13.16	4.825[c]	8.33

6

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Company	Billing date	Barrels lifted[a]	DOE base price	Contract discount	Average price paid[b]
			(dollars per barrel)		
Crysen Trading & Marketing, Inc.	4-08-86	8,599	$13.80	$5.043[c]	$8.75
	4-09-86	15,116	13.70	5.043[c]	8.66
	4-09-86	27,196	13.70	5.043[c]	8.66
	4-15-86	10,763	13.21	5.043[c]	8.16
	4-16-86	14,932	13.24	5.043[c]	8.20
	4-16-86	31,964	13.20	5.043[c]	8.16
	4-22-86	10,313	13.19	5.043[c]	8.15
	4-23-86	14,994	13.20	5.043[c]	8.16
	4-23-86	28,743	13.17	5.043[c]	8.13
	5-01-86	14,634	13.18	5.043[c]	8.14
	5-01-86	39,877	13.18	5.043[c]	8.14
	5-01-86	18,835	13.18	5.043[c]	8.14
	5-05-86	11,787	13.15	5.043[c]	8.11
	5-06-86	14,844	13.16	5.043[c]	8.12
	5-06-86	10,050	13.19	5.043[c]	8.15
	5-12-86	18,671	13.20	5.043[c]	8.16
	5-13-86	18,974	13.21	5.043[c]	8.17
	5-13-86	13,543	13.17	5.043[c]	8.13
	5-19-86	20,162	13.15	5.043[c]	8.11
	5-20-86	20,285	13.16	5.043[c]	8.12
	5-27-86	20,311	13.15	5.043[c]	8.11
	5-27-86	11,626	13.15	5.043[c]	8.11
	5-28-86	26,499	13.15	5.043[c]	8.11
Edgington Oil Co., Inc.	4-08-86	34,664	13.80	3.371[c]	10.43
	4-15-86	43,389	13.21	3.371[c]	9.84
	4-22-86	41,575	13.19	3.371[c]	9.82
	5-01-86	58,992	13.19	3.371[c]	9.82
	5-05-86	23,386	13.15	3.371[c]	9.78
	5-12-86	37,043	13.20	3.371[c]	9.83
	5-19-86	40,001	13.15	3.371[c]	9.78
	5-28-86	52,574	13.15	3.371[c]	9.78
Golden West Refining Co.	4-08-86	29,011	13.80	5.0735	8.72
	4-15-86	36,314	13.21	5.0735	8.13
	4-22-86	34,795	13.19	5.0735	8.12
	5-01-86	49,372	13.18	5.0735	8.11
	5-05-86	19,570	13.15	5.0735	8.08
	5-12-86	30,998	13.20	5.0735	8.13
	5-19-86	33,473	13.08	5.0735	8.01
	5-28-86	43,995	13.15	5.0735	8.08

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Company	Billing date	Barrels lifted[a]	DOE base price	Contract discount	Average price paid[b]
			(dollars per barrel)		
Kern Oil & Refining Co.	4-08-86	53,612	$13.80	$5.80	$8.00
	4-15-86	67,106	13.21	5.80	7.41
	4-22-86	64,300	13.19	5.80	7.39
	5-01-86	91,237	13.19	5.80	7.39
	5-05-86	31,165	13.15	5.80	7.35
	5-06-86	6,735	13.19	5.80	7.39
	5-12-86	49,364	13.20	5.80	7.40
	5-13-86	9,075	13.17	5.80	7.37
	5-19-86	53,306	13.15	5.80	7.35
	5-20-86	8,839	13.14	5.80	7.34
	5-27-86	7,791	13.15	5.80	7.35
	5-28-86	70,061	13.15	5.80	7.35
Lunday-Thagard Co.	4-08-86	23,107	13.80	4.28[c]	9.52
	4-15-86	28,923	13.21	4.28[c]	8.93
	4-22-86	27,714	13.19	4.28[c]	8.91
	5-01-86	39,324	13.19	4.28[c]	8.91
	5-05-86	15,592	13.15	4.28[c]	8.87
	5-12-86	24,698	13.20	4.28[c]	8.92
	5-19-86	26,669	13.15	4.28[c]	8.87
	5-28-86	35,052	13.15	4.28[c]	8.87
Macmillan Ring-Free Oil Co., Inc.	4-08-86	7,105	13.80	5.38	8.42
	4-15-86	8,894	13.21	5.38	7.83
	4-22-86	8,522	13.19	5.38	7.81
	4-22-86	3,537	13.07	4.87	8.20
	5-01-86	12,092	13.19	5.38	7.81
	5-01-86	3,494	13.32	5.38	7.94
	5-05-86	4,794	13.15	5.38	7.77
	5-06-86	6,128	13.49	4.87	8.62
	5-12-86	7,594	13.44	4.87	8.57
	5-13-86	6,940	14.46	4.87	9.59
	5-14-86	3,040	13.41	5.38	8.03
	5-19-86	8,200	13.15	5.38	7.77
	5-20-86	6,140	14.38	4.87	9.51
	5-23-86	2,583	14.38	4.87	9.51
	5-28-86	10,778	13.39	4.87	8.52

8

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Company	Billing date	Barrels lifted[a]	DOE base price	Contract discount	Average price paid[b]
			(dollars per barrel)		
Newhall Refining Co., Inc.	4-08-86	57,777	$15.59	$4.318[c]	$11.27
	4-09-86	22,911	13.80	4.318[c]	9.49
	4-09-86	13,267	13.80	4.318[c]	9.49
	4-15-86	73,320	13.21	2.524[c]	10.68
	4-16-86	31,954	13.32	4.318[c]	9.00
	4-16-86	15,546	13.28	4.318[c]	8.96
	4-22-86	69,295	13.19	2.524[c]	10.67
	4-23-86	13,756	13.27	4.318[c]	8.95
	4-23-86	20,407	13.28	4.318[c]	8.96
	5-01-86	98,325	13.18	2.524[c]	10.66
	5-01-86	23,421	13.23	4.318[c]	8.91
	5-01-86	17,219	13.20	4.318[c]	8.88
	5-05-86	38,982	13.15	2.524[c]	10.63
	5-06-86	24,560	13.25	4.318[c]	8.93
	5-12-86	61,747	13.20	2.524[c]	10.68
	5-13-86	31,255	13.30	4.318[c]	8.98
	5-19-86	66,677	13.15	2.524[c]	10.63
	5-20-86	29,721	13.21	4.318[c]	8.89
	5-27-86	35,880	13.25	4.318[c]	8.93
	5-28-86	87,635	13.15	2.524[c]	10.63
Oxbow Resources, Inc.	4-08-86	28,886	13.80	3.75[c]	10.05
	4-15-86	36,156	13.21	3.75[c]	9.46
	4-22-86	34,644	13.19	3.75[c]	9.44
	5-01-86	49,158	13.19	3.75[c]	9.44
	5-05-86	19,489	13.15	3.75[c]	9.40
	5-12-86	30,870	13.20	3.75[c]	9.45
	5-19-86	33,235	13.15	3.75[c]	9.40
	5-28-86	43,813	13.15	3.75[c]	9.40
Sound Refining Co.	4-08-86	28,845	13.83	4.2248[c]	9.60
	4-09-86	43	13.73	4.2248[c]	9.51
	4-15-86	36,106	13.21	4.2248[c]	8.98
	4-16-86	51	13.20	4.2248[c]	8.98
	4-22-86	34,596	13.19	4.2248[c]	8.97
	4-23-86	46	13.17	4.2248[c]	8.95
	5-01-86	49,089	13.18	4.2248[c]	8.96
	5-01-86	63	13.18	4.2248[c]	8.96
	5-05-86	12,943	13.15	4.2248[c]	8.93
	5-06-86	8,148	13.16	4.2248[c]	8.94
	5-12-86	20,501	13.20	4.2248[c]	8.98
	5-13-86	10,415	13.21	4.2248[c]	8.99
	5-19-86	22,138	13.15	4.2248[c]	8.93
	5-20-86	11,135	13.16	4.2248[c]	8.94
	5-27-86	11,149	13.15	4.2248[c]	8.93
	5-28-86	29,006	13.15	4.2248[c]	8.93

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Company	Billing date	Barrels lifted[a]	DOE base price	Contract discount	Average price paid[b]
			(dollars per barrel)		
U.S. Oil & Refining Co.	4-08-86	5,778	$13.80	$4.31	$9.49
	4-15-86	7,233	13.21	4.31	8.90
	4-22-86	6,930	13.19	4.31	8.88
	5-01-86	9,834	13.19	4.31	8.88
	5-05-86	3,897	13.15	4.31	8.84
	5-12-86	6,173	13.20	4.31	8.89
	5-19-86	6,666	13.15	4.31	8.84
	5-28-86	8,761	13.15	4.31	8.84

[a]Total barrels lifted (delivered) during billing period.

[b]Some items do not subtract due to rounding.

[c]Discount represents the average of discounts bid where companies submitted separate bids for each successive increment of oil quantities purchased, i.e., the first 1,000 barrels, the second 1,000 barrels, etc.

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Mr. SHARP. Thank you, Mr. Duffus. Mr. Cameron.

STATEMENT OF JOHN T. CAMERON

Mr. CAMERON. Thank you, Mr. Chairman. My statement is of record, and I will summarize it here.

I am John Cameron, vice president of Chevron U.S.A. And Chevron does support continued production of Elk Hills at maximum efficient rates of production. It is our practice where we operate oil fields throughout the world to produce all of them at maximum efficient rates.

Since the Sharp bill, H.R. 4843, would authorize production of Elk Hills at something less than the MER for reasons we consider inadequate, we oppose the passage of that bill.

Chevron does sympathize with the Government in its concern over selling its share of the Elk Hills production at the current depressed prices. But, we consider that the solution to that problem is merely to change the method by which the Government sells its crude oil in the future.

The Secretary of the Department of Energy has already ordered a study of the alternative methods by which the Government might sell its oil in the future. And we believe that those methods can be initiated administratively without legislation and without certain adverse side effects that we see from these pieces of proposed legislation.

We would urge that if any such bill is enacted that it provide that Chevron be allowed to continue to produce its equity share of Elk Hills based on the true MER's of the reservoir.

And, furthermore, we would expect to be protected on such issues as reservoir damage and increased operating costs during the Government's curtailment. It should be understood that curtailment of Elk Hills and virtually any other oil field would carry with it increased operating costs on a per barrel basis because of certain fixed costs that would not be reduced during curtailment.

The proposed bill and other similar bills seems also to assume that curtailment of Elk Hills would somehow benefit other producers, particularly those of stripper wells. We believe that in the San Joaquin Valley area, reduction of Elk Hills production would likely have the opposite effect.

I have detailed in my written testimony the several unfortunate side effects that Elk Hills' curtailment would cause generally on the refiners in the area and a certain class of producer in the area.

I wish to comment briefly on the recently released report of the DOE inspector general which contends that MER rates have been excessive in Elk Hills and that because of this large volumes of reserves may have been lost or are in jeopardy of being lost. Frankly, these issues of overproduction and lost recovery are quite out of date.

Although the inspector general report was issued only recently, it relies on certain memoranda that were written in 1983, now 3 years old. Since then, a lot has happened at Elk Hills. Comprehensive procedures to improve the engineering basis of MER determinations have been instituted since January of 1985 and studies of increased technical sophistication have been completed.

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Now, the results of these recent studies have confirmed that earlier MER rates were not excessive. The 1983 memoranda, though still being cited by the inspector general, are simply not valid.

Finally, I want to comment on the DOE Secretary's order of May 22. I've already mentioned that we are in sympathy with that part of the order that provides for a study of alternative means of selling the Government's crude. Furthermore, we have responded last week to a DOE questionnaire concerning suggested alternatives the Government might follow in the future.

I want to emphasize, however, that Chevron is not a party to the Government's current pricing problems. We are having no difficulty in getting rid of our crude from Elk Hills. We are not a buyer of the Government portion of crude under these contracts.

In short, it is not our problem. Yet, the May 22 order has ordered Chevron's production curtailed by 18 percent. And we consider this unfair.

Furthermore, that portion of the Secretary's order that orders Elk Hills curtailed is even more disturbing because it threatens to unravel a great deal of progress which has been made over the past couple of years in determining MER's at Elk Hills.

The divergent views of Chevron and DOE staffs have been well known in the past, but they have narrowed very substantially in recent times. And the Secretary's May 22 action departs dramatically from the January 1985 procedures which have now been followed.

That concludes my testimony.

[The prepared statement of Mr. Cameron follows:]

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CHEVRON U.S.A. INC., STATEMENT ON PRODUCTION OPERATIONS AT NAVAL PETROLEUM RESERVE NO. 1 (ELK HILLS, CALIFORNIA) PRESENTED TO THE HOUSE FOSSIL AND SYNTHETIC FUELS SUBCOMMITTEE OF THE ENERGY AND COMMERCE COMMITTEE AND THE SUBCOMMITTEE ON INVESTIGATIONS OF THE ARMED SERVICES COMMITTEE JUNE 11, 1986

My name is John T. Cameron, Vice President of Producing, Exploration and Land functions for the Western Region of Chevron U.S.A. I am pleased to accept the invitation extended to Chevron to participate in this hearing regarding Naval Petroleum Reserve No. 1. I plan to cover issues concerning current production at Elk Hills as well as those specifically mentioned in the proposed H.R. 4843.

H.R. 4843

As a joint owner of Naval Petroleum Reserve No. 1, Chevron supports the program of continued production at the Maximum Efficient Rate (MER). MER, as defined in Public Law 94-258, is "the maximum sustainable daily oil or gas rate from a reservoir which will permit economic development and depletion of that reservoir without detriment to the ultimate recovery." Let me emphasize here that industry practices are consistent with the spirit and intent of the law. It is Chevron's practice to produce all of its fields at MER.

H.R. 4843 would grant the President authority to set production rates from the Naval Petroleum Reserves at rates less than the MER for reasons relating to market conditions, and in particular for the purpose of preventing the sale of the Government's share of production at prices below prevailing market prices. Presumably, the author's concern arises principally from the fact that the Government is now selling its crude, during the period from April 1 to October 1, 1986, for prices substantially below prevailing market prices. Chevron sympathizes with the Government's concern over the current depressed prices being received by the Government for its crude. But the proposed bill is not an appropriate solution and could have unfortunate and unfair side effects.

The appropriate solution to the Government's pricing problem is merely to change the method used by the Government in selling its crude oil. The current method, though it has been used for years and has generally served the Government well, may not work well in highly unstabilized markets, when crude prices fluctuate rapidly as they did in January 1986, when the latest Government contracts were let. To avoid recurrences of the current or similar problems, the Government may choose to adopt a new or modified method. The Secretary of the Department of Energy has already ordered that alternative approaches be examined for the next round of sales, beginning October 1, 1986. An alternative method of sales can be initiated at that time which will

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avoid the current problems, and this can be done without legislation, and without adverse and unfair effects on other parties including the minority owner of Elk Hills.

H.R. 4843 has no provisions to protect Chevron's interest while the Government unilaterally reduces total field production merely to protect its financial interests. We would urge that, if any such bill is enacted, it provide that Chevron be allowed to continue to produce its equity share based on the true MERs of the affected reservoirs. Furthermore, the Government should not be allowed to make up, during the next period of MER production, the underproduction it suffered during the period the Government chose to curtail its production. If the Government is allowed to get back in balance by overproducing later, that would mean the Government would be allowed to produce preferentially at times of high price, while Chevron would be required to produce more in distressed markets. Finally, Chevron would expect to be protected on issues such as reservoir damage and increased operating costs during the Government's curtailment.

The proposed bill and other similar bills seem to be based in part on the assumption that curtailment of Elk Hills would somehow have a beneficial effect on other producers, particularly stripper well producers. In the San Joaquin Valley area, reduction of Elk Hills production will likely have the opposite effect. Much of the crude produced in the San Joaquin Valley is heavy, viscous production. The relatively light Elk Hills crude is needed to blend with the heavy crude so that it can be transported through pipeline systems to the various California refineries. Reduced Elk Hills production will increase transportation costs and/or reduce the amount of heavy San Joaquin Valley crude shipped to California refineries.

Reduced Elk Hills production will also impact San Joaquin Valley refiners which depend heavily on Elk Hills crude for their feedstock. There are inadequate alternative supplies of equivalent quality crude oil for these local refiners.

Reduction of Elk Hills production would have additional unfortunate downstream effects. The reduction in production would be replaced in California refineries by Alaska North Slope (ANS) crude. The ANS crude would be taken out of the U.S. Gulf Coast market, where it would be replaced by the most economic incremental crude available -- foreign crude oil. Thus, the reduction of crude produced in Elk Hills would contribute to higher imports. Incidentally, the additional ANS crude refined in California would yield substantially more residual fuel oil than would Elk Hills crude for the same volume of gasoline produced, aggravating the oversupply of resid on the West Coast.

Curtailment of Elk Hills oil production, if sufficiently severe, could cause Elk Hills gas sales to be reduced, which would, in turn, have adverse impacts on heavy oil production from steam drive fields in the area. Much of Elk Hills gas production is reinjected or used for fuel on lease. About 130 million cubic feet per day is sold, and most of

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that is used as fuel to generate steam in steam injection projects in nearby fields. This enables the production of about 40,000 barrels per day of heavy, viscous oil which is not otherwise recoverable. This production would be placed in jeopardy if Elk Hills were shut in or severely curtailed.

Inspector General's Report

I wish to comment briefly on the recently released report of the DOE Inspector General which contends that MER's established by DOE for the last several years were excessive. The I.G. report also found that studies prepared by DOE engineers and consultants "indicate that 90 to 130 million barrels of otherwise recoverable oil is at risk of being lost through overproduction over the life of the reserve."

Frankly, these issues of overproduction and lost recovery are quite dated. Although the I.G. report was issued only recently, we note the conclusions were reached in early 1985, the audit having been conducted more than a year ago. It is also clear that these I.G. claims are largely a reproduction of a General Accounting Office report released almost two years ago (July 1984). The GAO report, in turn, was based on certain memoranda written by DOE's Elk Hills staff in 1983, now almost three years old. Since then, comprehensive procedures to improve the engineering basis of MER studies were initiated in early 1985 and studies of increased technical sophistication have been made subsequently. The results of these recent studies confirmed that earlier MER rates were not excessive.

As an example, a comprehensive reservoir engineering study was conducted over the past year investigating MER for the Stevens Zone 26R reservoir, the largest reservoir at Elk Hills. Final documentation of this study was provided in February 1986. The study incorporated investigations of reservoir geology, production facilities, and gas processing facilities, and was centered on a state-of-the-art computer simulation study of the reservoir gravity drainage mechanism. The study concluded that recovery for the 26R reservoir is not sensitive to production rate over the range of production rates cited in the I.G. report (i.e. 25,000 to 50,000 bpd). Rates can be increased from current levels without detriment to ultimate recovery.

It is generally agreed among the DOE, Bechtel, and Chevron technical staffs that this most recent engineering study of 26R is the best technical investigation made to date of MER for any Elk Hills reservoir. This comprehensively documented study demonstrates that the 1983 memoranda, though still being cited in the I.G. report, are not valid. Let me add that the DOE technical staff at Elk Hills has agreed with an operating strategy for the 26R reservoir based upon the results of this recent reservoir study and has, in fact, recommended that production from this reservoir be increased. Ironically, 26R production will be curtailed to some degree by the May 22 order of Secretary Herrington, contrary to technical recommendations.

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The primary basis used by the I.G. for estimates of recovery losses is a series of reports by the DOE Elk Hills technical staff written in late 1983. Chevron has reviewed these reports in detail, and we find no engineering justification for claims of lost recovery. The DOE reports referenced by the I.G. basically extrapolated past reservoir performance in an attempt to estimate future recovery. The reports then compared these estimates with earlier recovery estimates derived from unrelated studies such as volumetric estimates for equity determinations. The difference was asserted to be recovery "lost" due to supposed excessive producing rates. This is simply an indefensible engineering approach.

In the October 3, 1984, congressional hearings considering production alternatives for Elk Hills, DOE's Director of Naval Petroleum and Oil Shale Reserves testified that these 1983 reports took "a very pessimistic, very limited view and analysis" and that the analysis "was mixing apples and oranges." He further detailed a considerable list of technical deficiencies of these reports. Chevron agreed then and agrees now with the Director's assessment of the reports.

As an owner of UO-NPR-1, it is clearly in Chevron's business interest to obtain the highest ultimate recovery from the field. The value of potential reserve losses cited by the I.G. is "between $1.60 billion and $2.30 billion." Chevron could not support production practices by the DOE which could conceivably result in even a small fraction of such losses. Our policy in all operations is to maximize ultimate recovery. Elk Hills is no exception. We firmly believe that no losses in ultimate recovery are attributable to past or current production rates.

Secretary Herrington's May 22, 1986 Order

Chevron has been asked to comment on the DOE's order of May 22 concerning Elk Hills production and the pricing of Government crude sales. I have already mentioned that Chevron recognizes that the system currently employed by the Government to sell its crude may be in need of modification. We sympathize with the Secretary's order to consider alternative methods. Furthermore, we responded last week to a DOE questionnaire concerning suggested alternatives the Government might use in the future.

I want to emphasize, however, that Chevron is not a party to the Government's crude pricing problems. We are not having any similar problems disposing of our share of Elk Hills crude, and we are not a buyer of Elk Hills crude under the current contracts -- in short, it is not our problem. Yet, by the May 22 action, we have been ordered to curtail our production by 18% merely because the Government is not satisfied with the price it is receiving during this one six-month period, for its crude. The curtailment portion of the order is unfair to Chevron. Furthermore, it seems unfair to the purchasers of the Government's crude, since it is, in effect, an attempt to circumvent contracts which the Government now sees as disadvantageous to its interests. I would think that simple fair play should dictate that DOE would merely resign itself to live with these contracts until October 1, correcting their bidding practices for the future. This is particularly

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so since, in the past, the DOE contracts under current bidding practices have more often than not realized a bonus over prevailing area posted prices, and the Government has not offered to let the crude buyers off the hook in those times when the Government was enjoying comparatively attractive prices.

That portion of the Secretary's order which curtailed Elk Hills production is even more disturbing because it threatens to unravel a great deal of progress which has been made over the past couple of years in determining the MERs at Elk Hills. The divergent views of Chevron and DOE staffs have narrowed substantially, thanks in part to more formalized procedures implemented by DOE in January 1985. The Secretary's May 22 action departs dramatically from this course, selecting a production rate which seems completely arbitrary and is sharply less than that agreed to by concensus of DOE and Chevron engineers.

The 26R reservoir, once again, is a graphic example. Because of the comprehensive study of this reservoir which was completed in February 1986, the Chevron and DOE technical staffs recently agreed that the reservoir MER should be increased to at least 36,000 BPD (from the current production level of about 31,000 BPD). With the Secretary's May 22 order, production from this reservoir will instead be reduced to about 20,000 BPD. This new rate is not an MER established through sound engineering practices.

Conclusion

Let me conclude by making these points:

- We believe that the field should be produced at the best technically derived MER.

- If the Government is dissatisfied with the price it receives for its crude and chooses to modify its method of sales, Chevron should not be penalized by suffering losses in production and revenue while the Government is attempting to solve its marketing problems.

- Reduced production at Elk Hills will negatively impact certain producers and refiners in the local San Joaquin Valley area.

- We disagree with the I.G. report that the field has been overproduced and that reserves have been lost.

This concludes my testimony. I appreciate the opportunity to express Chevron's views on these complex matters. I would be happy to answer questions or elaborate on any points which I have presented.

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Mr. SHARP. Thank you very much, Mr. Cameron.
Mr. Stephen Berg-Hansen with the Independent Producers.

STATEMENT OF STEPHEN BERG-HANSEN

Mr. BERG-HANSEN. Thank you, Mr. Chairman. I am appearing here today on behalf of the 835 companies which are members of the California Independent Producers Association.

The association represents independent oil and natural gas producers and associated service and supply companies with operations in California.

My purpose in appearing here today is not to criticize DOE managers. We think the Naval Petroleum Reserve Act of 1976 is as much at fault in the outcome of the sale as the decisions of the managers, and we very much appreciated the involvement of Secretary Harrington in instituting new bidding procedures and working with us in the last couple of weeks.

I do, however, want to explain how the recent sale has affected independent producers and offer our suggestions for changing the NPR bidding procedures.

Very briefly, the Independent Producers just don't feel that they can compete under the current DOE system when they have to fight the Federal Government for a share of the marketplace. DOE's sales guidelines stand in stark contrast to the methods employed by private companies and other Gyovernment agencies which also sell large quantities of oil in California.

For instance, the Department of Interior, through the Mineral Management Service, sells Federal royalty oil in California under a policy which requires payment of the highest posted price for each field in which such oil is produced. In the same vein, the State of California demands the highest market price when selling State royalty oil under its auction system.

In considering the legislation which you have introduced and which we support, it may be useful to understand the manner in which the operation of the Elk Hills reserve has affected small producers.

In contrast to the relatively small volumes of oil produced by independents, the Federal production from the Elk Hills reserve represents nearly 10 percent of all oil produced in the State of California, or the single largest block of crude oil that is not controlled or owned by a major oil company in the State. Equally important is the fact that unlike the lower quality, heavy oil produced by independents, the Elk Hills reserve produces the high quality crude that is preferred by refiners.

Accordingly, Elk Hills sale had an immediate impact on spot market prices and the purchase contracts offered to independent crude oil producers.

After the apparent winning bids were announced in the January 1986 auction, contracts for purchase of independently produced crude were almost immediately canceled or modified to reflect the Elk Hills sales price. I have attached a letter sent by one of the winning bidders out to independent producers. It reflects the fact that he was only willing to pay for independently produced crude oil at a discount of $4.50.

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The letter was sent out the day after the DOE auction. Other winning bidders merely canceled their contracts.

These actions, in effect, broke the market and sent spot prices sharply lower. The results of the DOE selling procedure and the world market downturn have had an overall devastating effect on independent producers operating in the San Joaquin Valley and elsewhere in California.

Right now, in California we have an estimated 100,000 barrels per day of production shut in because of the current market. Nearly all small producers without continuing contracts have been unable to sell their oil at posted prices or anything near posted prices until the last few weeks.

Price cuts have forced oil prices in the San Joaquin Valley and elsewhere within the State to the lowest levels in the United States. Some small producers have been forced to sell their production to waste oil haulers for as little as $5 a barrel in the San Joaquin Valley, when posted prices were $10 per barrel or more.

In Kern County alone, an estimated 4,500 oilfield jobs, nearly a third of all such jobs in the county, have been lost since the end of 1985. More than 10,000 low-volume wells have been shut in throughout the State.

In associated industries, the impact is even more devastating. Dozens of drilling, service, and supply companies have been forced to go out of business.

CIPA believes that if the DOE is to continue selling crude oil from the naval petroleum reserve, the sales should be made at or very near market prices. We have worked with the Department in considering a number of bidding and contracting options which will prevent the type of contracts which are now in place. CIPA and other interested parties have had an opportunity to discuss the changes with DOE policymakers, and we feel confident that they are sincere in their desire to make the changes.

In our comments, we have stressed the need for a bidding system that is simple and market responsive. We emphasized that any new system should include a requirement for more frequent sales, a shorter sales contract, the incorporation of a minimum bid or a floor price, and a drastic reduction of the time between the bidding and the actual delivery of the crude oil.

As mentioned earlier, CIPA members also favor shutting in the reserve if market prices are not achieved through the bidding process. We just don't want to ever again see a situation like we have now in effect in California.

If we were to stress a single important change, it would be the need to hold monthly sales or bimonthly sales for a 60-day contract at Elk Hills. Each sale would include one-half the crude available for sale.

This mechanism would tie the sales procedure closely to the market and enable the DOE to closely match its contract prices with market changes. But we think the most critical aspect of this change is that it would result in frequent and intense competition for the right to purchase Elk Hills crude oil.

As an added benefit, we believe that frequent sales and shorter contract periods would encourage crude oil purchasers to maintain

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their contracts with independent producers rather than canceling such contracts upon winning a major allocation of Elk Hills crude.

Thank you very much for allowing me to be here. And I hope that we can help the committee staff in developing answers and information that might arise about the system out in California.

[The prepared statement of Mr. Berg-Hansen follows:]

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California Independent Producers Association

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Testimony Of The California Independent Producers Association

An Independent Producer Perspective On The Problems Caused

By The Sales Procedures Used At

The Elk Hills Naval Petroleum Reserve

Presented By

Stephen Berg-Hansen, Executive Vice President

Before The

Fossil Fuels Subcommittee

Of The House Energy and Commerce Committee

June 9, 1986

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Mr. Chairman and members of the committee, my name is Stephen Berg-Hansen and I am appearing here today on behalf of the 835 companies which are members of the California Independent Producers Association (CIPA). The association represents independent oil and natural gas producers and associated service and supply companies with operations in California.

CIPA members have been the victims of the policies which resulted in the recent market-breaking sales of crude oil from the Elk Hills Naval Petroleum Reserve. Department of Energy managers apparently ignored the potential impact of their decision last March to award the current sales contracts, and as a result, the federal government will lose, by our estimate, more than $50 million before the end of the current contract period. A loss has also been felt by CIPA members who have to compete against the prices established by DOE bidding procedures to sell their crude oil.

Chairman Sharp correctly identified the primary problem to be addressed in these hearings when he described the Department of Energy's oil reserve management as a "buy high, sell low U.S. oil reserve policy."

Our purpose in appearing here today is not to criticize DOE managers. The Naval Petroleum Reserve Act of 1976 is as much at fault in the outcome of the recent sale as any DOE management decisions. We do, however, want to explain how the recent sale has affected independent producers and offer our suggestions for changing the NPR bidding procedures.

First, I would like to offer CIPA's views on the policy which we believe should govern the disposition of crude oil from the naval petroleum reserves.

Policy Considerations

CIPA members believe that it was a mistake to accept the bids for the current contracts. The department had the option to renew the then existing contracts or to rebid the oil. Instead, the decision was made in March to allow the winning bidders the right to buy the oil at a price based on January bid discounts, even though the base reference price, upon which the orginal bids were made, had declined dramatically. DOE's largess in awarding the bids surprised even the winning bidders.

Independent producers cannot compete against sales under the current system and believe that federal sales below market prices are ill-advised and unnecessary. DOE's sales guidelines stand in stark contrast to the methods employed by private companies and other government agencies which also sell large quantities of oil in California. For instance, the Department of the Interior, through the Mineral Management Service, sells federal royalty oil in California

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under a policy which requires payment of the highest posted price for each field in which such oil is produced. Similarly, the State of California demands the highest market price when selling state royalty oil under its auction system.

When challenged on their pricing policies, DOE managers have cited the need to sell all of the oil from the reserve which is produced at its maximum efficient rate (MER). Departmental spokesmen defended the sale by saying that even with a discount of more than $6.00 a barrel, the government was making money on Elk Hills crude and that it would remain "profitable" until prices sank below $5.00. (Investors' Daily, April 10, 1986)

We believe that Elk Hills crude oil should not be sold at extreme discounts or below prices achieved by other producers. If the sales procedure employed fails to provide current market prices, the only defensible alternatives are to either shut in Elk Hills or send crude oil produced from the reserve to the Strategic Petroleum Reserves in Texas and Louisiana via pipeline. We understand that crude could be shipped through the All American Pipeline at a cost of between $2.50-3.00 per barrel.

The Problems Caused By The Most Recent Elk Hills Sale

In considering the legislation now before the committee, it may be useful to understand the manner in which the operation of the Elk Hills reserve has affected small producers.

The reserve is located in the San Joaquin Valley, a large area of California that contains major oil fields which produce more than 700,000 barrels of oil per day. While most of the larger fields are controlled and operated by major oil companies, a hundred or more small companies produce heavy viscous crude from small scattered leases. These producers have no market power, and they derive their income solely from sales of crude oil. They are, therefore, at the mercy of fluctuations in the crude oil market.

In contrast to the relatively small volumes of oil produced by independents, the federal production from the Elk Hills reserve represents nearly 10 percent of the oil produced in California, or the single largest block of crude oil that is not controlled or owned by a major oil company. Equally important is the fact that unlike the lower quality, heavy oil produced by independents, the Elk Hills Reserve produces the high quality crude oil preferred by refiners.

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Accordingly, Elk Hills sales had an immediate impact on spot market prices and the purchase contracts offered to independent crude oil producers.

These effects are particularly important during a volatile crude oil market which has been the case during the last six months. This is not to say that the 55-60 percent decline in California crude oil prices was attributable to the Elk Hills sale. However, the impact of market disruptions on the independent producers was exaggerated by the Elk Hills sale. Let me explain.

After the "apparent" winning bids were announced in the January 1986 auction of 80,000 bpd (to be delivered during the period April 1, 1986 to October 1, 1986), contracts for purchase of independently-produced crude oil were almost immediately either cancelled or modified to reflect the Elk Hills price.

As shown in Exhibit One (attached), some of the winning bidders immediately notified independent producers that their contract prices would be subjected to a $4.50 per barrel discount reflecting the average of the winning bids at the auction. Other winning bidders merely cancelled their contracts. These actions, in effect, "broke the market" and sent "spot" prices sharply lower. Within weeks many San Joaquin Valley independent producers were unable to sell their oil at the "posted" prices offered by major oil companies. Others were unable to sell their oil at all.

The results of the DOE selling fiasco and the world market downturn have been devastating to independent producers operating in the San Joaquin Valley. Consider the following impacts:

*An estimated 100,000 barrels per day of production is shut-in throughout California.

*Nearly all small producers without continuing contracts have been unable to sell their oil at posted prices.

*Price cuts have forced oil prices in the San Joaquin Valley and elsewhere within the state to the lowest levels in the United States.

*Some small producers have been forced to sell their production to waste oil haulers for as little as $5 a barrel, at a time when posted prices were more than $10 per barrel.

*In Kern County alone (the largest county in the valley), an estimated 4,500 oilfield jobs, nearly a third of all such jobs in the county, have been lost since the end of 1985.

*More than ten thousand low-volume, marginal wells have been shut-in.

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*Millions of barrels of heavy crude oil reserves may be lost.

*Dozens of drilling, service and supply companies have been forced to go out of business.

Changes That Must Be Made

To a great degree, the problems with the bidding and sales procedures at Elk Hills have arisen because of the restrictions and directives included in the Naval Petroleum Reserve Act of 1976. Departmental managers have felt that the requirements for producing the reserves at maximum efficient rates and other restrictions such as the delay caused by the anti-trust review, have tied their hands with respect to alternative sales procedures. However, the incredible windfall now being received by purchasers of Elk Hills crude oil simply cannot be explained away by such procedural difficulties.

CIPA believes that if the DOE is to continue selling crude oil from the Naval Petroleum Reserves, the sales should be made at or very near market prices. During the last week, we have learned that the department is considering a number of bidding and contract options which will prevent the type of contracts which are now in place. CIPA and other interested parties have had an opportunity to discuss changes with the DOE policymakers and feel confident that they are sincere in their desire to make changes.

In our comments, we have stressed the need for a bidding system that is simple and market responsive. We emphasized that any new system should include:

1) a requirement for more frequent sales,

2) a shorter sales contract,

3) the incorporation of a minimum bid price, and

4) a drastic reduction of the time between the bidding and actual delivery of the crude oil.

As mentioned earlier, CIPA members also favor shutting in the reserve if "market prices" are not achieved through the bidding process.

If we were to stress a <u>single</u> important change it would be the need to hold monthly sales for 60-day contracts at Elk Hills. Each sale would include one half of the crude available for sale. This mechanism would tie the sales process closely to the market and enable the DOE to closely match its contract prices with market changes.

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The most critical aspect of this change is that it would result in frequent and intense competition for the right to purchase Elk Hills crude oil. An added benefit, we believe, is that frequent sales and shorter contract periods would encourage crude oil purchasers to maintain their contracts with independent producers rather than cancelling such contracts upon winning a major allocation of Elk Hills crude.

CIPA's Support For H.R. 4843 and H.R. 4859

We have analyzed the provisions of H.R. 4843, introduced by members of this committee and H.R. 4859, introduced by Representative Thomas, and totally support the general concepts embodied in both.

We favor a legislative mandate that would shut in the NPRs if crude oil produced from them cannot be sold at the current prevailing market price in the region in which it is produced. We also favor providing wide discretion to the DOE in formulating new bidding procedures and alternative methods of disposing of production, such as storing it in the Strategic Petroleum Reserves or selling it in other than local markets, as specified by the Thomas bill.

With respect to the Elk Hills Reserve, however, it should be understood that there is another factor affecting the West Coast market. There is a surplus of crude oil in California caused by the prohibition on the export of Alaskan North Slope (ANS) crude oil. Alaskan oil is flooding West Coast markets (see attached Oil Daily article), a relatively recent condition which has arisen along with major price declines.

Prior to the price collapse of recent months, a major portion of ANS crude was shipped to the Gulf Coast, because the cost of transporting it was almost totally subsidized in the form of deductions from the Windfall Profits Tax (WPT) paid to the federal government and from other taxes paid to the State of Alaska. However, during recent months prices have fallen below the threshhold price for imposition of the WPT, and there is little economic incentive to ship ANS crude beyond the California market. Unless the price of ANS crude were $1.50-$2.00 per barrel higher in the Gulf Coast market than in California, a condition which rarely occurs, large volumes of ANS oil will be available to West Coast refiners at distressed prices.

Since Elk Hills crude oil and Alaskan oil produce a higher percentage of gasoline and other valuable products, their continued presence in the marketplace further depresses posted prices for California's predominantly heavy high sulfur crudes (some posted prices are now as low as $6.00 per barrel) and pushes non-contract sales even lower.

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Conclusion

Mr. Chairman, members of our association deeply appreciate the concern that you and other members of the committee have shown about the Elk Hills issue. We recognize that there are many issues which demand the subcommittee's time and attention. Nevertheless, we believe that it is important that swift action be taken to amend the legislation which authorizes crude oil sales from the Elk Hills Naval Petroleum Reserve.

In our testimony and separate comments delivered to DOE, CIPA has suggested reasonable changes that could be made in the bidding procedures and in the law which governs the operations of the naval petroleum reserves. Independent producers would prefer not to compete against the federal government when selling their crude oil in the California market. However, if it is determined that such sales must continue, we urge that private companies be protected from competing against a federal agency's "sell at any cost" strategy.

Thank you for the opportunity to appear.

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January 28, 1986

Commander Oil Company, Ltd.
5900 Wilshire Blvd, Suite 605
Los Angeles, CA 90026

Attention: Mr. Lysle Snow

SUBJECT: CRUDE OIL PRICING

Dear Lysle:

This is to advise you that effective February 1, 1986, Beacon Oil Company will pay the highest price for the referenced oil as posted by Mobil, Chevron and Union in your field, minus $4.50 per barrel, in effect on the date of delivery.

If you have any questions regarding the above, please do not hesitate to contact me.

Very truly yours,

BEACON OIL COMPANY

Kenneth J. Kross
Crude Oil Representative

KJK/cvn

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THE OIL DAILY, WEDNESDAY, MAY 14, 1986

WELL WATCH *By Jim Drummond*

California Independents Face Disaster with Strange Twist

DISASTER WITH A twist has struck independent California oil producers. They are inundated by a sudden tide of Alaskan crude.

The tide is a side effect of the collapse of world oil prices. Oddly enough, the independents' best ally for a while was the petroleum industry's most hated burden. Until crude started trading beneath the level at which the windfall profits tax takes effect, this levy had absorbed an estimated 90 percent of the cost of moving Alaskan barrels to refineries along the Gulf of Mexico and to other areas outside California.

With such movements no longer economic, the California Independent Producers Association (CIPA) has started trying to reverse the federal ban on exports of Alaskan crude.

"The government hasn't taken any definitive action yet, although we understand that the Commerce Department has completed a study," CIPA Executive Vice President Stephen Berg-Hansen told Well Watch.

He said the White House is supposed to have received an analysis last week of conditions in Alaska, whose producers are forced to sell into the glutted California market for less than they could get elsewhere.

Aggravated by Elk Hills

California problems are augmented, said Berg-Hansen, by federal production and sale of 125,000 barrels of oil daily from the Elk Hills Naval Petroleum Reserve at prices $4.40 a barrel beneath the average for comparable California oil.

"A number of small refiners and brokers participated in one winning bid $6.30 a barrel below par," he said. "Wholesale cancellations of contracts with producers followed. One refiner said he would continue to buy from independents, but for less money."

How did the California oil glut come about and how bad is it?

The West Coast petroleum market is among the world's most complex, CIPA's top staffer observed. For lack of a large east-west or west-east liquids pipeline, it's isolated. The opening of the Trans-Alaska pipeline changed it from a net crude importer to an exporter.

Between 1979 and 1981, when the price of Alaskan crude exceeded federal ceilings, North Slope producers were indifferent to where the oil was peddled. Any added transportation charge, as to the Gulf Coast, was subsidized by "entitlements" which equalized refiner costs.

After deregulation, the windfall profits tax performed much the same function.

Competing Head-On

Recently, however, generally inferior California crudes, which average about 2 percent sulfur and 18 gravity, have had to compete head-on with the Alaskan commodity, which averages 1.6 percent sulfur and 27 degrees API gravity and compares favorably with Saudi Arabia's light "marker" crude as to product yields and refining netback.

Because of the ban on North Slope exports, Alaskan oil has been offered in Los Angeles harbor for as little as $10 a barrel, Berg-Hansen reported. So it is supplanting heavy California crudes and depressing the prices of some desirable grades to as little as $5 to $6 a barrel.

Worse still, he said, many of California's small producers can't sell their oil. An estimated 7,500 to 10,000 of the state's 55,000 wells have been shut in within the last two months, a dramatic drop in the number of independent refiners and producers has occurred, and some 15,000 oil company jobs have been lost.

Conservation has been hit, too. Several of California's vast enhanced recovery projects have been halted or delayed. These and others like them are counted upon to produce the highly viscous oils which make up most of the Golden State's proved reserves, still only 75 percent produced.

Enhanced recovery is expensive and can't be undertaken at today's California crude prices, Berg-Hansen noted. Yet without remedial measures, prices of both California and Alaskan oil will fall into a long-term decline, he warned.

Advocates Export Sales

CIPA recommends that Congress and the administration permit as much as 500,000 b/d of North Slope oil to be sold to Pacific Rim purchasers. Exports should continue "until an equilibrium in west coast crude oil demand and supply is once again achieved."

This should improve North Slope crude prices and permit present domestic users of Alaskan to select more California heavy, increasing economic efficiency all the way around, Well Watch was told.

Who opposes Alaskan exports? "No" voters are said to range from interests involved in Jones Act requirements for coastal shipping in U.S. bottoms to the Seafarers Union and environmental groups who fear that better California crude prices would step up offshore exploration. At least one big, oil-short West Coast refiner will profit from the weak crude market as long as west coast product prices remain relatively higher than those elsewhere in the United States, Well Watch sources said.

Berg-Hansen joined CIPA three years ago after duty with Champlin Petroleum in Washington, D.C., and Union Pacific Corp. in Colorado. There's an irony in his background, he confessed. In the nation's capital he had worked on issue papers which advocated the opening of the Elk Hills reserve as a "Project Independence" move.

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Mr. SHARP. Thank you, Mr. Berg-Hansen. We now welcome Mr. Bob Redd.

STATEMENT OF BOB REDD

Mr. REDD. Mr. Chairman, I've submitted my testimony for the record, and I'm just going to highlight it here.

My name is Bob Redd. I'm vice president for Crude Oil Supply of Golden West Refining Co., an independent refiner located in Santa Fe Springs, CA. I am here today on behalf of the American Independent Refiners Association, which is the only trade association which speaks for independent refiners.

Twelve of our members are located on the west coast. Many of these members rely heavily on Elk Hills crude oil as a significant source of their raw materials supply.

The continued availability of this crude oil at a competitive price is of grave concern to them, and it's essential to the economic well-being of many of them. Together with independent marketers, independent refiners have historically exerted an influence on the market.

This influence has led to increased competition and lower price for consumers. Independent refiners have also historically been the largest purchasers and paid the highest price for Elk Hills crude oil.

On contracts recently we have purchased as much as 83 percent of the total volume. On average for the last seven contracts, we have purchased directly from the DOE 53 percent of that volume. In addition to this, we do purchase in the secondary markets as much as 25 percent of the Elk Hills crude oil production, which finds its way there.

As Mr. Berg-Hansen pointed out, Elk Hills does represent the single largest block of crude oil in California that is not owned or controlled by a major oil company. Elk Hills is a principal source of light sweet crude oil, which is essential to the independent refiners who do supply aviation fuels to the military.

The production of Elk Hills does also benefit heavy crude in the San Joaquin Valley, either as a result, as we have already heard, of the associated gas which is used in enhanced oil recovery projects or to facilitate its transportation to market in the Los Angeles Basin.

Without Elk Hills crude oil, refiners would be faced with higher transportation costs for their crude oil, poorer crude quality, poorer yields, and all this would eventually lead to higher costs for consumers.

Without Elk Hills, landlocked refiners in the San Joaquin Valley might not find adequate alternative supplies of light sweet crude oil to continue their operations.

We are here today because it is evident that the system by which Elk Hills crude is sold is in need of change. And we, too, are in agreement that this change needs to be a market-responsive change. We need a market-responsive price. We've maintained this for some time. This situation has finally brought it to a high level of visibility.

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In the past few weeks, our group has been back here and we have been meeting with several Members of Congress and their staffs, the Department of Energy. We have also met with our own membership, members of the California Independent Producers Association and their individual members, as well as the transportation companies involved in the movement of Elk Hills crude oil.

And there are many points on which we are all in agreement. Among them are the need for more frequent sales; and commensurately, the need for shorter contracts. We, too, have no opposition to a minimum sales price as long as that minimum sales price is market-responsive.

And we don't have any problems with reducing the time from the bid to the start of the contract, and we would support such an action.

The DOE did, on May 30, request that comments be submitted on five alternative pricing measures. We submitted comments to them. Due to the rules of testimony covering this hearing, we were not able to include them in our testimony but I do have a copy of them here with me today, and if you so desire I would be happy to submit them for the record.

There are, however, a few points that we have uncovered that we don't agree on. And those are: We are opposed to the shut-in of the reserve. We feel it should continue to be produced. We do favor maintaining the statutory requirement prohibiting the export of Elk Hills crude oil or the products derived from that crude oil.

We do favor maintaining the statutory requirement limiting purchases to 20 percent of the reserve's production. And we are opposed to any measures which would cause Elk Hills crude oil to be diverted from its historical market.

In closing, I would like to say that whatever changes are made must be administratively workable and commercially sound. With respect to H.R. 4843, we agree with it in principle; however, there are a few points in the bill that we do think need some clarification. We have communicated those desires to staff and are willing to work with staff in incorporating them into the bill.

Finally, I would like to say that we haven't had an opportunity to review the other written testimony that has been submitted here today. We would appreciate your holding the record open for a brief period of time to give us the opportunity to do so.

And, I thank you for having had the opportunity to appear here today.

[Testimony resumes on p. 116.]

[The prepared statement and attachment of Mr. Redd follows:]

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Testimony of
THE AMERICAN INDEPENDENT REFINERS ASSOCIATION

Before the
SUBCOMMITTEE ON FOSSIL AND SYNTHETIC FUELS
Of the
HOUSE COMMITTEE ON ENERGY AND COMMERCE

And the
SUBCOMMITTEE ON INVESTIGATIONS
Of the
HOUSE COMMITTEE ON ARMED SERVICES

June 11, 1986

I am Bob Redd, Vice President for Crude Oil Supply, for Golden West Refining Company, an independent petroleum refiner located in Santa Fe Springs, California. I am here today representing the American Independent Refiners Association, the only trade association which speaks for independent refiners. Twelve of our members are located on the West Coast and many of us rely on Elk Hills crude oil as a significant source of our raw material supplies.

The continued availability of Elk Hills crude oil at competitive prices is of grave concern to our members and is essential to the economic viability of West Coast independent refiners. Independent refiners supply independent marketers, and together with them we have historically exerted a powerful competitive influence on the marketplace by competing on the basis of price, resulting in significant cost benefits for consumers.

I. ELK HILLS CRUDE OIL IS CRITICAL TO THE WEST COAST MARKET

Independent refiners are the largest market for Elk Hills crude oil. For the last seven contract periods, independents have directly purchased an average 53% of the Elk Hills crude oil sold by the Department of Energy (DOE). At times independent refiners' direct purchases from DOE have been as high as 83% of total available crude oil. In addition, our analysis indicates that independents from time to time purchase as much as an additional 25% of the Elk Hills production in secondary markets, from resellers.

Elk Hills represents the single largest block of crude oil production not controlled by major integrated oil companies in the California market. For many independent refiners, Elk Hills represents the only available supply of the light, relatively sweet crude oil needed to meet strict California environmental limitations while at the same time producing products which meet the needs of the local market. Moreover, Elk Hills crude oil, given its characteristically high yield of turbine grade fuels, is particularly essential to West Coast independent refiners who have been historical suppliers of substantial volumes jet fuel to the military.

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Of the total 1,126,000 barrels per day of California crude oil produced in 1984 (the most recent year for which comprehensive production figures are available), over 950,000 barrels per day, or 85%, were owned or controlled by major integrated oil companies or were under long-term contract and therefore not available. Thus, only approximately 170,000 barrels per day of California production were potentially available. Of this, over half was composed of Elk Hills crude oil offered for sale. This left only approximately 85,000 barrels per day of crude oil potentially available from private producers. Suitable replacements for Elk Hills crude oil generally are not available to independent refiners. For these reasons, the continued availability of Elk Hills crude oil at competitive prices is of grave concern to us.

The importance of Elk Hills crude oil is not limited to the direct impact upon independent refiners, however. Approximately 40,000 barrels per day of California heavy crude oil production depend on associated natural gas produced from Elk Hills. This gas is used to generate steam for enhanced oil recovery projects in Western Kern County.

Furthermore, approximately 57,000 barrels per day of heavy California crude oil can be transported to market by pipeline only because that heavy oil is mixed with the lighter Elk Hills crude oil, thus reducing its viscosity and improving its quality. Inasmuch as existing heavy crude oil pipeline systems are currently at capacity, absent Elk Hills crude oil this heavy production would have to be transported to market via more costly methods such as trucking or rail. The higher costs associated with these forms of transportation might raise the price to the point where there is no longer a market and the production has to be shut in.

If Elk Hills production were not available, the combined effect of higher transportation costs, poorer crude oil quality, and poorer product slates would lead to higher product costs for West Coast consumers. Remaining light crudes would be available only within a price structure unrelated to their market value, further contributing to higher finished product prices.

Landlocked San Joaquin Valley independent refiners are particularly dependent on Elk Hills, and currently refine approximately 42,000 barrels per day of Elk Hills crude oil, for which they have no substitute. At least some refiners in the San Joaquin Valley would be forced to close their facilities or drastically curtail their operations if the Elk Hills crude oil were unavailable. The products manufactured at these refineries would have to be replaced in the local market with products from coastal refineries, at increased costs to area consumers.

Furthermore, change to Elk Hills operations would have an additional economic impact. According to Chevron USA, Inc., 800 persons are directly employed in the Elk Hills operation. Approximately $75 million is spent annually for supplies and services. The State of California receives approximately $23 million annually in taxes attributable to Elk Hills. Local governments receive an additional $12 million in annual tax revenues.

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Finally, as a result of the associated gas produced with Elk Hills crude oil, for each barrel of Elk Hills crude oil produced the nation's balance of payments is improved, as 1¼ barrels of imported oil are displaced.

The worldwide petroleum industry has undergone unprecedented changes in the last few months, which have resulted in the restructuring of many companies, alteration of long-standing market relationships and, in some instances, chaotic market behavior. Under these circumstances, updating the mechanism by which Elk Hills crude oil is sold is appropriate. However, this must be undertaken with great care, in order to avoid future West Coast market disruptions.

II. PRICING MECHANISM

A. The Current System

Elk Hills crude oil is currently sold by competitive bids for six-month terms. Bids are submitted more than 60 days before the first delivery of crude oil under the contracts. Bidders bid either a bonus above or discount below a base price, which is not necessarily reflective of, or responsive to changes in, the market value of Elk Hills crude oil. This price mechanism, combined with the unprecedented decline in the crude oil markets which occurred during the period between the most recent bid date and the date of first delivery of crude under the contract, is primarily responsible for the current criticism associated with the last sale.

The timing of the most recent sale (which timing was dictated by the prior contract expiration date) could not have come at a more inopportune time, falling as it did in the midst of the greatest crude oil price decline in history. In the two weeks immediately preceding the sale, the market for crude oil in California had begun a sharp decline. By the date of the sale (January 27, 1986), prices for comparable crude oil were more than $6.00 per barrel below the then current base price for Elk Hills crude oil.

The bids submitted by independent refiners and others appear to reflect the great disparity that existed between posted prices for crude oil and the crude oil's market value at that time. Because posting reductions have historically lagged the market by several months, prudent bidders apparently discounted their bids to compensate for the risk associated with this historical time lag. This perception of risk is supported by the fact that during the period beginning with the decontrol of crude oil on January 27, 1981, and continuing through January 30, 1986, there had been a total of twelve changes made to the California postings from which the base price for Elk Hills crude oil is determined. To date since February 1, 1986, there have been nine such changes.

In the last sale, DOE fell victim, as did many refiners, producers and marketers, to the unprecedented market collapse experienced in the first quarter of 1986. In contrast, since 1983, when outright sales of NPR crude oil were resumed, DOE had consistently sold its production at prices above the NPR base price and postings.

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As a result of the prices which DOE is receiving for its most recent sale of Elk Hills crude oil, the flaws and inequities of the present pricing system are highly visible. However, for years these problems have been evident to us, as the ultimate purchasers of this crude. Since April 1, 1986, DOE has sold Elk Hills crude oil for as much as approximately $6.00 per barrel below its apparent market price. But one only has to look back to February 1986 to see that purchasers were then paying DOE as much as $7.00 per barrel over market price on contract purchases of Elk Hills crude oil. At that time, it was purchasers who were sustaining losses. We would like to note that, despite these substantial losses, which threatened our very existence, AIRA members who held contracts performed.

B. Market Responsive System

Market responsive pricing is necessary to insure that a distorted outcome, as in the most recent sale, does not recur, even in the event of an extremely volatile market before or after the sale. Additionally, market responsive pricing should insure maximum revenues to DOE from sales of Elk Hills crude oil, regardless of whether the market rises, falls or is stable.

On May 30, 1986, DOE published a Notice describing five alternative sales methods being considered to replace the current pricing mechanism. Four of the alternatives are market responsive; one is not. Three of the market responsive alternatives establish the price for Elk Hills crude oil based on an index of crude oil prices on the West Coast. The other market responsive alternative indexes the Elk Hills crude oil price to a predetermined sampling of West Coast petroleum product prices.

The crude oil-based indexes are desirable because they:

- Are market responsive;
- Maximize revenues to DOE;
- Should increase competition by attracting a greater number of bidders; and
- Reduce uncertainty in bidding.

The index based on product prices is less desirable because it:

- Is based upon predetermined and nonvarying percentages of products which are expected to be produced from Elk Hills crude oil. Many bidders do not produce any products (because they are not refiners) or do not produce them in the predetermined proportions; and
- Requires substantially more manpower and effort to administer, thus increasing both costs of administration and the likelihood for errors or disputes to arise.

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The fifth alternative, a fixed price for sixty days, is not a desirable sales method because:

- In a rising market, a fixed price will prevent DOE from participating in that increase, and therefore from maximizing revenues;
- In any market (rising, falling or stable), a fixed price will prevent DOE from realizing the maximum revenues because of the increased risk due to market uncertainty;
- If this alternative were combined with a floor price as proposed in some legislation, and there were even a modest rise in the market, an immediate shut-in or substantial curtailment of Elk Hills production would be required; and
- With shorter contract periods than currently exist, purchasers will be required to unnecessarily duplicate the security they post and this may eliminate bidders who must use their available lines of credit for other purchases that do not require duplicate coverage.

III. OTHER CHANGES IN SALES PROCEDURES

We would like to take this opportunity to state our position on a few other changes mentioned recently regarding the manner in which Elk Hills crude oil is sold:

- We favor reducing the time between the IFB publication date and the bid opening to 15 days.
- We support the DOE proposal to shorten to 45 days the time from the IFB to first crude oil delivery.
- We favor retaining notification of bidders of contract award prior to the tenth day of the month preceding the month of first delivery.
- We favor bid opening on Thursday, after 3:00 P.M. EST/EDT.
- We favor retaining incremental (multiple) bidding.
- We strongly urge retaining the statutory 20% MBTU equivalent maximum allowable purchase by a successful bidder. This limitation was required in order to:
  - minimize DOE's economic risk of selling a larger volume to a single purchaser who proved economically unable to perform;
  - minimize DOE's risk of having to dispose of crude oil at distressed prices if a purchaser of a large volume was unable to accept delivery and DOE's limited storage capability was full;

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- minimize the threat to the national security by disbursing the crude oil to numerous refiners who produce fuel for both military and civilian use, rather than selling a larger volume to a few refiners who would thus be more susceptible to military attack or mechanical interruption; and

- assure independent refiners, who historically supply a substantial proportion of jet fuel and other products to the military, of access to this vital raw material supply.

- We strongly urge retaining the statutory prohibition on the export of Elk Hills crude oil or petroleum products produced from it.

- We favor recalculating the security requirement for Elk Hills when the variance reaches 10%, more or less, than the last security.

- We would support reducing the sales term of the contract to 90 days, with the government having the right to extend for an additional 30 days.

- Diversion of Elk Hills crude oil from the California market would have the same devastating effect on West Coast independent refiners as would a total shut-in of Elk Hills.

IV. RATE OF PRODUCTION

We are not in a position to comment on what is the most efficient rate at which Elk Hills crude oil should be produced. However, our members are severely disadvantaged if a reduction in that rate is announced without sufficient advance warning to allow for locating alternative supplies. Early consultation with our members regarding changes in production levels would allow for an orderly transition and time to locate alternative supplies of crude oil, thus reducing the immediate and adverse impact on consumers of unnecessarily raising petroleum prices.

V. SALE OF THE NAVAL PETROLEUM RESERVE

We have not yet completed our formal position on sale of the Reserve. However, the timing seems poor, given the recent substantial reduction in crude oil value. If the Reserve is sold, the sale must provide for the permanent and uninterrupted supply of crude oil from the Reserve to West Coast independent refiners.

We would be pleased to address any questions you may have, and we appreciate the opportunity to appear before you. We also would like the opportunity to supplement the record in this matter with a further written statement addressing some of the issues which have been focused upon here today.

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THE ROLE OF ELK HILLS PRODUCTION IN THE CALIFORNIA MARKET

PREPARED BY

THE

AMERICAN INDEPENDENT REFINERS ASSOCIATION

In the past several weeks, there has been a great deal of concern expressed over the Department of Energy's most recent sale of crude oil from NPR1 (Elk Hills). This concern implies that many of the problems currently being experienced by independent producers in California have been further aggravated specifically as a result of this sale. This is not correct. Moreover, it has been suggested that, in general, continued sales from NPR1 will have a disruptive effect on the market and, as such, are the major contributing factor to continued depressed prices for California crude oil. This is also incorrect.

The American Independent Refiners Association would like to take this opportunity to offer comment on the unprecedented market conditions which influenced the sale in question, as well as, call attention to the vital role the operation of NPR1 plays in the California marketplace.

The recent sale of Elk Hills crude was not responsible for breaking the California market as has been suggested. In the two weeks preceding the sale in question the "spot market" for crude in California had begun a sharp decline. By the date of the sale, January 27, 1986, spot prices were in excess of $6.00 per barrel below the then current posted prices for crude oil of similar quality to that produced at NPR1.

The bids submitted by independent refiners and others were reflective of the great disparity that existed between posted prices for crude and the crude oil's true market value at that time. Because posting reductions have historically lagged the market by several months, prudent bidders obviously discounted their bids to compensate for the risk associated with this relationship. This perception of risk is supported by the fact that during the period beginning with the decontrol of crude oil in January of 1981, and continuing through January 30, 1986, there had been a total of twelve (12) changes

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made to the California postings from which the base price for Elk Hills crude is determined. Two of the aforementioned changes were increases; the remaining ten were decreases. To date since February 1, 1986, there have been nine (9) such changes, all of them reductions.

The Department of Energy fell victim, as did many refiners, producers and marketers, to the unprecedented market collapse experienced in the first quarter of 1986. However, to imply that the DOE was negligent in its disposition of a valuable government resource or in any way at fault or contributed to the recent market declines is unfounded and unfair. In fact, since 1983, when outright sales of NPR crude were resumed, the DOE had consistently sold its production at prices above the NPR Base Price and Postings.

AIRA does not feel that the sale in question was at fault or contributory to the price decline in the California market. To assume so would be extremely naive and short-sighted. Likewise, AIRA does not see any benefit to the market in proposals or suggestions which give consideration to shutting in the reserves, redirecting the reserves production to alternative markets; using the reserves to fill the Strategic Petroleum Reserves, or dramatically changing the terms and conditions under which production from the reserves is sold.

AIRA feels that were production from the reserves curtailed or its method of distribution and sale changed, the problems currently being experienced by the independent producer in California would not be resolved and would in fact be further aggravated. The following information with respect to the effect of shutting in or diverting Elk Hills production is offered in support of this position:

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EFFECT ON CALIFORNIA PRODUCTION

- Associated gas benefits enhanced oil recovery and steam generation projects supporting 60,000 barrels per day of heavy crude production in adjacent fields. Due to severe California and Kern County air quality regulations, this source of fuel cannot be replaced by alternate fuels.

- Were the 80,000 barrels per day of Elk Hills crude currently being shipped on the Four Corners Pipe Line no longer available, 10,000 to 30,000 barrels per day of heavy crude would be displaced. Inasmuch as alternate heavy crude pipeline systems are currently at capacity and trucking the crude to market is generally not economically viable, it is likely the affected production would have to be shut in.

EFFECT ON BALANCE OF PAYMENTS

- Each barrel produced at Elk Hills displaces approximately 1.5 barrels of imported oil due to benefits attributable to associated gas production.

EFFECT ON NPR1

- Geological studies indicate shut in or curtailment could cause the loss of from 5% to 15% of the ultimate recoverable reserve through bypassed oil and uncontrolled fluid migration.

- Nine to twelve months would be required to restore the field to its maximum efficient rate. Therefore, it is possible that production would not be available in the event of a national emergency.

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EFFECT ON STATE AND LOCAL GOVERNMENT

- Eight hundred persons are directly employed in Elk Hills operation. Approximately $115 million are spent annually for supplies and services. The State of California receives approximately $23 million annually in taxes attributable to Elk Hills. Local governments receive an additional $12 million in annual tax revenues.

EFFECT ON EXISTING PIPE LINES

- Would cause Four Corners Pipe Line (FCPL) to operate at greatly reduced rates.
- Would create a significant decrease in the common stream quality of the crude shipped on FCPL.
- Due to lack of space on other pipe line systems would cause heavy production to back up in the San Joaquin Valley.
- Would increase potential for shut in of additional heavy crude production.
- Would increase the cost of transporting crude to market.

EFFECT ON INDEPENDENT REFINERS

- Would remove the single largest block of crude production not controlled by a major oil company from the California market.
- Many independent refiners would be unable to acquire suitable replacement crudes for the Elk Hills production.
- The heavier crude available on FCPL would cost more to refine, yield a poorer product slate, and have a much more limited market than currently exists.

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EFFECT ON CONSUMERS

- The combined effect of higher transportation costs, poorer crude quality, and poorer product slates will lead to higher product costs for the consumer than might otherwise occur. Remaining light crudes would take on a price structure unrelated to their market value further contributing to higher finished product prices.

- Refiners in the San Joaquin Valley would be forced to close their facilities if unable to replace the Elk Hills crude. (The equivalent of 27,000 barrels per day of Elk Hills crude oil is currently refined in the San Joaquin Valley.) The product manufactured at these refineries would have to be replaced in the local market with products from coastal refineries at an increased cost to the consumer.

EFFECT OF DIVERSION

- Were Elk Hills crude diverted to the Strategic Petroleum Reserve via the All American Pipe Line, the effect on California production, Four Corners Pipe Line, Independent Refiners, and the Consumer would be the same as would be experienced under a shut in scenario.

- It is also highly unlikely that the California producer would benefit by being able to ship heavy production to the gulf on the back of diverted Elk Hills production. An analysis of the economics associated with such a move suggests that the netback to the producer would be significantly lower than the California market currently provides.

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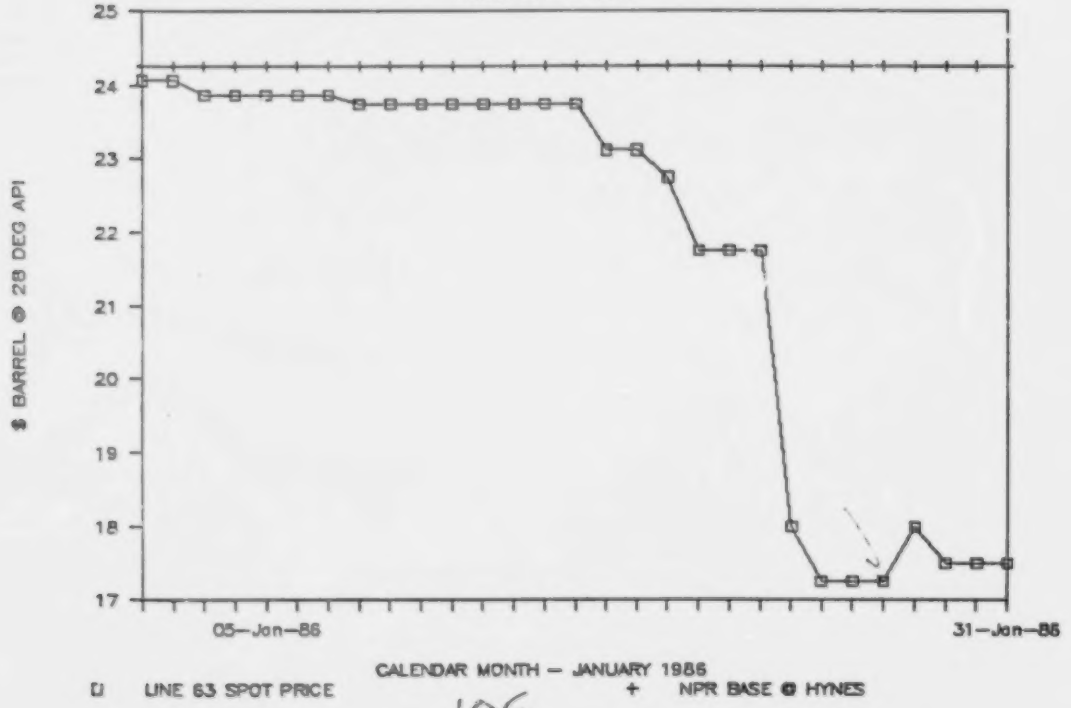
ELK HILLS CONTRACT VS. LINE 63 SPOT

PRICE COMPARISON



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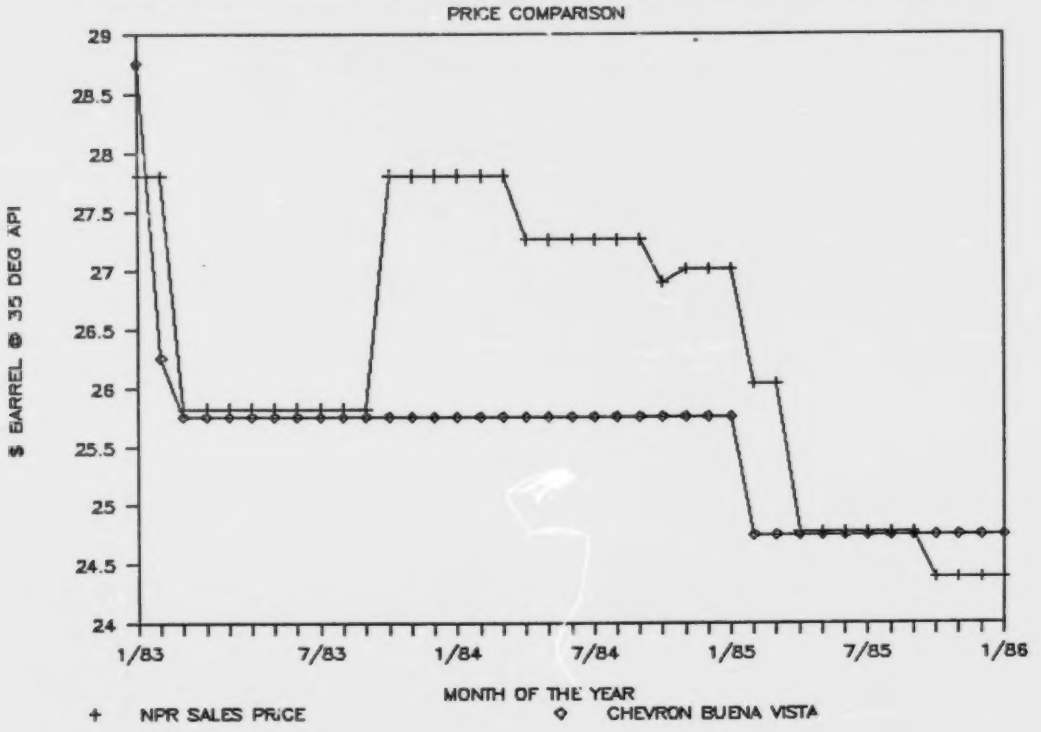
CHEVRON BUENA VISTA POSTING / NPR SALES



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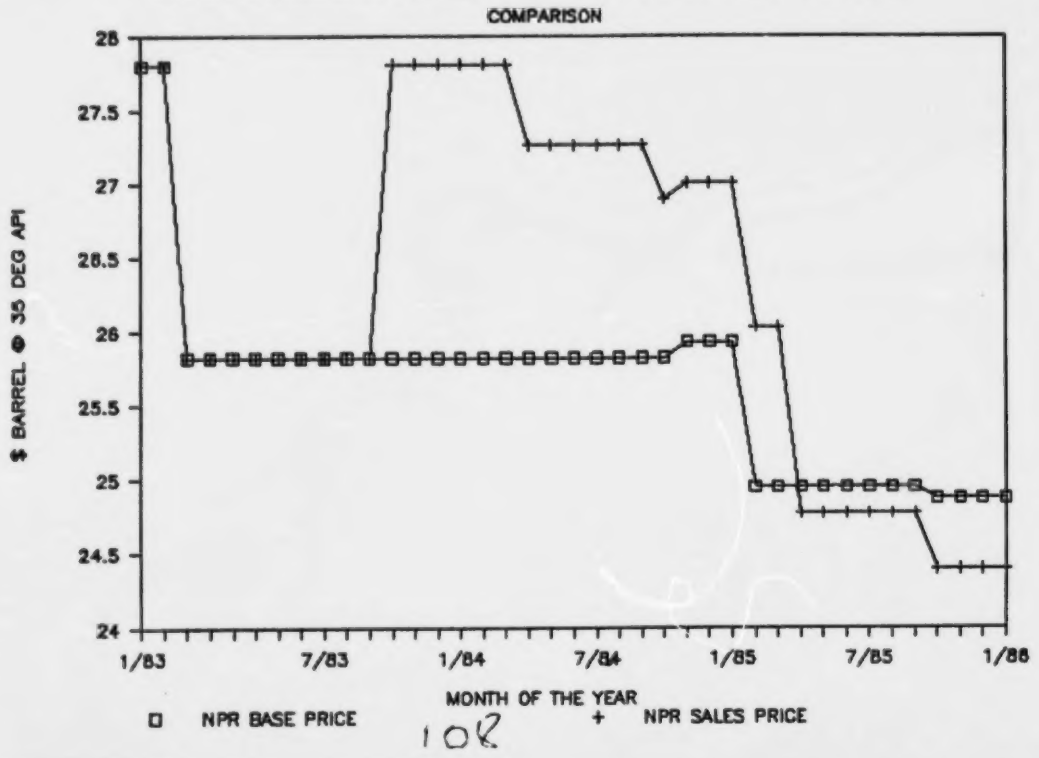
NPR BASE PRICE VS. NPR SALES PRICE



FOUR CORNERS PIPE LINE COMPANY

LINE 1/63 OPERATION

SCOPE OF OPERATION: Gathering of crude oil in Southern San Joaquin Valley and transportation of same to refineries located in the Bakersfield area, as well as the Los Angeles Basin.

CAPACITY:

SYSTEM:	140,000 Barrels Per Day
LINE 1:	35,000 Barrels Per Day
LINE 63:	105,000 Barrels Per Day

QUALITY REQUIREMENTS: Crude oil tendered for shipment must be a minimum of 27° API.

ELK HILLS:

Total Crude Production: Approximately 125,000 Barrels Per Day

Distribution:	Four Corners Pipe Line	80,000 Barrels Per Day
	Movement North (Bakersfield)	25,000 Barrels Per Day*
	Movement South (Los Angeles)	55,000 Barrels Per Day
	Chevron Pipe Line	35,000 Barrels Per Day
	Trucks	10,000 Barrels Per Day

* Elk Hills production moved North is replaced in the Southern system by crude produced from the Yowlumne oil field. Were Elk Hills crude not available, studies conducted by FCPL indicate that the Yowlumne crude would remain in the San Joaquin Valley.

- At present FCPL estimates they are able to move 26,000 B/D of 13° API crude on back of the 80,000 B/D of Elk Hills production in the system.

- Were the Elk Hills production shut in or diverted from its present distribution pattern, the API gravity of the Line 1/Line 63 system would be reduced from its current level of 30° API to somewhere in the range of 17° API to 21° API.

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Four Corners Pipe Line Company - Line 1/63 Operation

- Were Elk Hills shut in or diverted, FCPL would cease operation of Line 1. This would have an adverse impact on 20,000 B/D of Ventura area production gathered into the system at Newhall and 7,000 B/D gathered into the system in the Los Angeles Basin.

- Were Elk Hills shut in or diverted, the ability to thruput Crude on Line 63 would be drastically reduced. FCPL calculates that the system's operating rate would range from 30,000 B/D at 17° API to 50,000 B/D at 21° API.

- A capital investment of $25,000,000 and two years lead time would be required for FCPL to modify its system to accommodate the movement of heavy crude at rates approximating 75,000 to 100,000 B/D.

- A tariff increase of approximately 100% to $1.00 barrel would be required to short term, compensate the carrier for loss of revenue attributable to volume reduction and long term, recoup their $25,000,000 capital investment.

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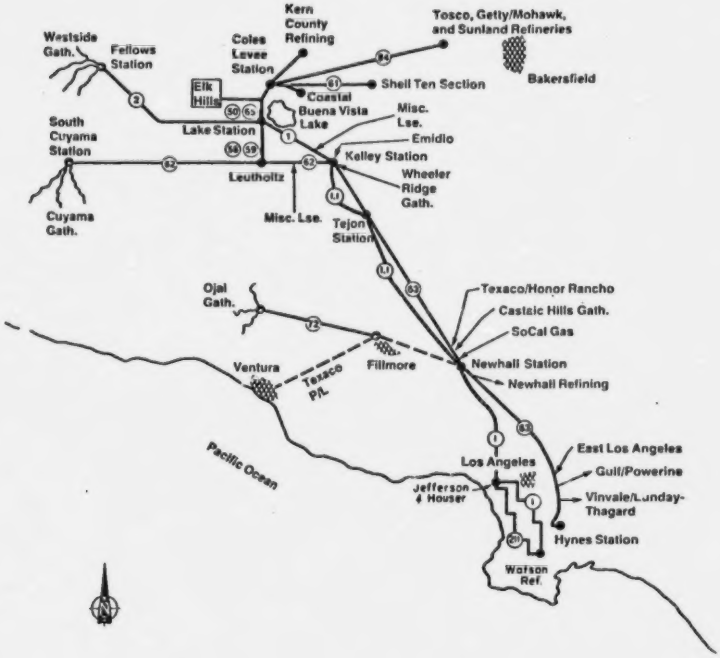
Four Corners Pipe Line Company
San Joaquin Valley/L.A. Basin Operation



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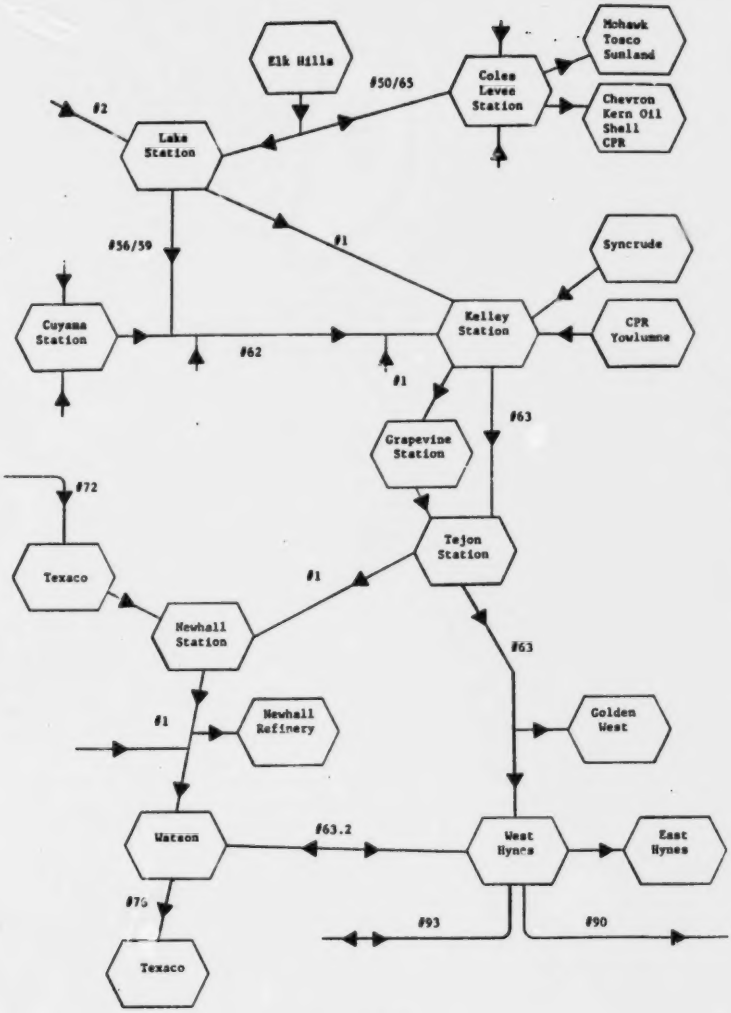

LINE 1 & 63
TRUNKLINE SYSTEM

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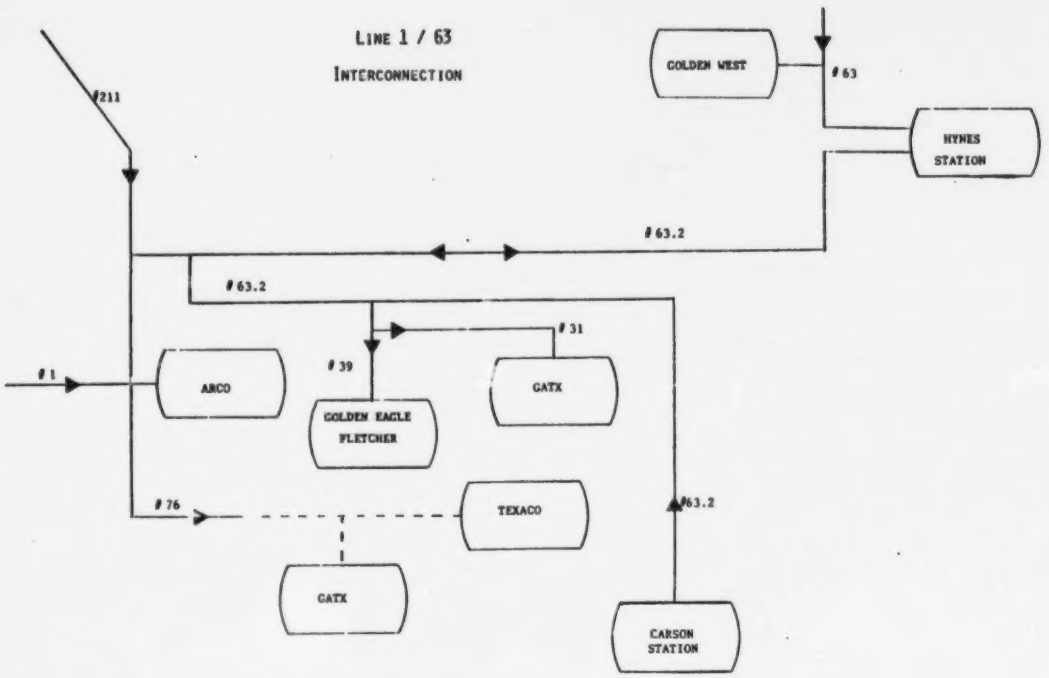

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ECONOMICS
OF
U.S. GULF COAST AS ALTERNATIVE MARKET FOR
CALIFORNIA HEAVY PRODUCTION

ASSUMPTIONS:

Value of West Texas Intermediate Crude Oil per NYMEX closing as of 5/15/86.

All American Pipe Line Tariff estimated $3.50 per barrel, Bakersfield to Houston.

Gravity adjusted per industry practice in California. Gravity of heavy crude tendered for shipment to Gulf at 13° API.

Quality differential based upon current U.S. Gulf Coast differential for ANS vs. WTI.

Location differential Cushing, OK to Houston, TX $0.50 Barrel.

	$/BBL.
Value WTI	16.00
All American Tariff	(3.50)
Gravity Adjustment	(3.75)
Quality Adjustment for Sulfur	(1.70)
Gathering-Field to AAPL Entry (est.)	(.75)
Net to Producer	6.30

Note: Producer could bear additional costs attributable to Time Value of Money dependent upon pipeline transit time and terms of sale at destination.

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Mr. SHARP. Thank you. We customarily do hold our record open for 2 weeks. And if there are others who wish to submit testimony, or those who have testified and want to add to the record, we will be happy to make these additions a part of the record.

Let me ask you Mr. Cameron, on Chevron's part, I assume the sales you were making of your oil, which you rightfully have ownership to, I assume you did not get yourselves into contracts like the Department has itself into in terms of being as much as $7 below posted price.

Mr. CAMERON. No, sir. We have not had those difficulties. We take our own oil, as a matter of fact, to one of our—to California refineries. So, we move that and use internal transfer prices which are the posted prices to make those transactions.

Mr. SHARP. Mr. Redd, I'm told that some of the refiners in the area—Mr. Berg-Hansen testified to that effect—have canceled contracts.

I don't know what the terms of those contracts are, but the refiners obviously felt the prices had gotten out of line with what was happening in the marketplace.

Am I—is Mr. Berg-Hansen wrong about that? Can you enlighten us?

Mr. REDD. Well, I'm here representing an association today. I can't say I have any specific knowledge of what any of our members may have done.

I have no reason to doubt Mr. Berg-Hansen. And having seen his testimony, I am aware of the letter he included in it. But, I can't comment as to the specifics of what any one company may have done.

Mr. SHARP. You are associated with one particular refining company; is that correct?

Mr. REDD. Yes, I am.

Mr. SHARP. Has that company in the last 6 months, to your knowledge, canceled any contracts with producers?

Mr. REDD. No, we have not.

Mr. SHARP. Mr. Berg-Hansen, in terms of the contracts canceled, can you enlighten us at all whether you feel they were just a direct abrogation of the contract or under what terms they were abrogated?

Mr. BERG-HANSEN. I can't speak to the specific terms and contracts that were broken. I know from talking with many, many members of our company, members of our association that are small companies operating throughout California, that a large percentage of them had contracts canceled and have had a very difficult time selling their crude oil in the last several months.

And everyday when I pick up my telephone to talk with producers, we hear horror stories about how they have had to move their crude oil at huge discounts or the fact that some of them haven't been able to sell their crude oil at all.

Mr. SHARP. Mr. Duffus, it's GAO's understanding that the Secretary could legally abrogate the contracts—or, is that a contradiction in terms—that are in existence for that crude that is substantially below, the market right now?

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Mr. DUFFUS. Yes, Mr. Chairman. Under the terms of the contract, the Secretary of Energy can cancel the contracts without liability.

Mr. SHARP. Do you think there is any serious litigation problem? I mean, anyone can file suit obviously. The question is whether there are a series of court cases that are, in fact, tending toward saying you can't?

Mr. DUFFUS. Well, I'm not an attorney, Mr. Chairman. But, in discussion with our attorneys on this matter, it's their opinion that the liability clause has not been tested, and it could result in claims against the Government should purchasers be unable to find alternative sources of supply.

Mr. SHARP. But, based on not being able to find supply; is that what you are saying?

Mr. DUFFUS. That's correct.

Mr. SHARP. Finding equally cheap oil?

Mr. DUFFUS. That's correct.

Mr. SHARP. Does anyone think there is any likelihood that any current purchaser of oil from the NPR could not find alternative supply?

Mr. BERG-HANSEN. Mr. Chairman, our association doesn't favor breaking the contracts. But, we do believe that California is awash in crude oil. It's mainly Alaskan crude oil that is in surplus in California.

But, we have taken a neutral position as an association on the contract issue.

Mr. SHARP. Let me raise the question on the MER. I think Mr. Cameron and Mr. Redd, I believe both of you indicated you believe the field ought to be operated at MER.

The question that is before us—and there is some dispute on Capitol Hill, as was indicated by a couple of the gentlemen from the Armed Services Committee as to what the long-term policy of the country ought to be in terms of the purpose of this reserve, but the general proposition and certainly the current policy and current law is to produce and sell it at MER.

The concern that our legislation reflects is that that requirement has led to, in part, and especially the initial responses to why all this happened. Mr. Cameron, do you believe the law ought to dictate MER? Would you be uncomfortable with discretion being to the Secretary to determining that policy other then MER?

Mr. CAMERON. I believe the best use for Elk Hills is to produce it at the MER in accordance with existing public law. I think that is the best value that will be realized by the owners, including Chevron and the Government, the taxpayer, from continued production at the MER.

I do not believe that the law requiring production at the MER is responsible for the pricing difficulties that the Government now finds itself in, and I believe that those problems can be solved merely by changing the method.

It should be reminded that the existing system has worked for 10 years to the Government's benefit, in fact, and all those years, most of the time the Government was realizing a bonus rather than a discount over posted prices.

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Mr. SHARP. You understand, obviously, under the law there are two broad options that the Department has. One is maintaining—barely maintaining the field and the other is—at MER, though we have seen now there is considerable flexibility in assessing what MER is.

In your kind of responsibility, would you want to have dictated to you that those are the only two options you have in operating that field. Is that the smartest way for you to do business?

Mr. CAMERON. I don't think additional flexibility is needed by the Secretary or by any other operator of an oil field, because they are operated by everyone in the oil business at MER rates, and options of reducing them to some other rate may be legally available to those other operators, but in practice they don't follow them.

Mr. SHARP. Mr. Redd do you have a comment on that.

Mr. REDD. The only thing I would like to say with respect to that is what constitutes the MER is a complex technical question which we are really not prepared to address. Given our limited understanding of the issue, however, we feel it should be produced at that MER but that it is up to the technical people, the reservoir engineers and geologists to determine that.

Mr. SHARP. Mr. Berg-Hansen, do you have any different perspective on that.

Mr. BERG-HANSEN. I think there are wide opinions about what maximum efficient rate actually means, and I think from the perspective of our association we would rather see it at the low end of the estimates rather than at the high end, or above the MER's as has happened in the last year or so.

Mr. SHARP. I can certainly understand in this market climate your folks opting for the lowest end of that. It is economically understandable.

Well, gentlemen, I appreciate your help today on this issue, and it is obviously one that will continue to get attention at the Department and the various Committees on Capitol Hill. We will hold the record open for any additional comment you may have.

Thank you very much for being with us.

[Whereupon, at 12:45 p.m., the joint subcommittees adjourned.]

[The following material was received for the record:]

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RECEIVED
1986 JUN 11 PM 4:57
U.S. HOUSE OF REPRESENTATIVES

June 3, 1986

Congressman John D. Dingell
2221 Rayburn Building
Washington D. C., 20515

Reference: Naval Petroleum Reserve, Elk Hills (NPR-1)

Dear Congressman:

I appreciate the opportunity to convey these facts about Naval Petroleum Reserve (NPR-1) crude oil production at the Elk Hills Field, California. I have worked 10 years in the crude oil supply business in California as Crude Oil Representative for Tosco Corporation, a large independent refiner, and Manager of Crude Oil Supply for USA Petroleum Corporation, a small independent refiner and retail gasoline marketer. Recently, I have been retained as a consultant to a large independent producer of California crude oil and a West Coast product marketing company. I am also a member of the California Independent Producers Association.

I understand that there are now Bills before the Legislature which either restrict or eliminate the production of Elk Hills Crude Oil. I feel strongly that we should continue to produce Elk Hills at the maximum efficient rates of production for these reasons:

1. Following the 1973-74 Arab Oil Embargo, which demonstrated the Nation's vulnerability to oil supply interruptions, the Congress in 1974 authorized and directed that the Naval Petroleum Reserves be explored and developed to their full economic and productive potential. In 1976, Congress passed the Naval Petroleum Reserves Act (Public Law 94-258), which required that the Petroleum Reserves be produced at their maximum efficient rates of production for six years with Presidential extensions thereafter.

As a net importer of crude oil supplies, a reduction of Elk Hills production, second in size only to Prudhoe Bay, will require a barrel for barrel replacement by foreign oil and thus, increase this Nation's dependence on foreign oil. Recent history clearly demonstrates the hazards of this kind of national policy.

2. Most of California's crude oil is heavy and highly viscus- over 65% is 20 degrees or heavier whereas in the rest of the country, about 5% is in this range. This crude is so heavy and viscus that it is expensive and sometimes impossible to transport and refine without dilution with lighter crude. At 35 degrees

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API. Elk Hills is the primary crude used for dilution.

Without Elk Hills crude available for dilution, it may not be possible to transport all the heavy crude produced in California. For many refineries it is not possible to substitute heavy for light crude in the refining process. These refineries will process less crude in total. Further, without the ability to dilute the existing supply of heavy crude, these refineries must also refine less heavy crude, meaning: a planned cut in light crude production will cause a sympathetic cut in heavy crude production. This will also lead to an increase in gasoline imports into the West Coast from the present foreign sources in the Far East.

3. Since the inception of production of Elk Hills, this crude has been a critical source of supply for small refiners. The importance of this crude which can be acquired without reliance upon major oil companies, can be demonstrated by their active participation in the competitive bi's. Without this source of supply small refiners may not be able to compete with vertically integrated majors with "in house" crude supplies.

Independent producers do rely on the independent refiner counterpart to maintain competitive outlets for crude oil production. The economic demise of the independent refiner in California would be detrimental, not only to the government sales program and the Department of Defense fuels acquisitions, but to independent producers as well. The DOE also recognizes the importance if the independent element in the marketplace, by giving small refiners a preference on 25% of the Elk Hills volume available for sale.

4. Opponents of continued Elk Hills production state that the West Coast suffers from lower prices than the rest of the nation, a symptom of the over supply of Alaskan Oil. To the extent that the West Coast prices are lower by the amount of transportation costs from the West to Gulf Coasts, this is true. However, the amount of Alaskan crude moving to the Gulf Coast is over five times the total production rates of Elk Hills so it is unlikely that any production change, including a total shut-in, would have a material effect on prices.

To prove this consider what happened when DOE announced the recent 23% reduction in production effective June 1. The announcement came on the last full business day prior to pipeline nomination closing. Companies with Elk Hills crude in their supply picture suddenly needed additional crude so began searching for replacement supplies. Since it was the last day, most suppliers had committed all supplies so the price suddenly rose about $1.00 per barrel. Since then, the price of crude in the Gulf Coast has declined to where Alaskan oil there is below the market price on the West Coast. Sellers of Alaskan oil are selling the oil to West Coast buyers at atttractive prices causing the West Coast price to fall. Today the price of Elk Hills is actually below where it was when the production cut was announced.

The real result of shut-in Elk Hills crude production will

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be the transfer of all significant oil available for sale to California refiners into the hands of Alaskan oil producers mainly Standard Oil (SOHIO), a foreign owned and controlled corporation.

5. Some will say that the crude oil must be refined and therefore should be sold directly and exclusively to refiners. This, they contend, would eliminate the middlemen, and presumably allow refiners and the government a larger share of the profit. There are two gross errors in this theory. Firstly, the refiners will indeed capture a higher profit because they will be able to bid less for the oil without the added competition from traders. A quick review of past bids will reveal the fact that traders have bid higher prices than refiners. Does the government want to sell the oil for less? Secondly, several traders have processing arrangements with refiners to process the Elk Hills crude into products in order to satisfy product needs. It would be arbitrary and capricious for the government to preclude this viable industry segment from competitive bids.

Thank you again for this opportunity to express my views. I would be happy to answer questions you have about this important issue.

Sincerely yours,

Eric S. Bradley
President

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champlin

A Subsidiary of
Union Pacific Corporation

June 23, 1986

The Honorable Philip R. Sharp
Chairman, Subcommittee on
Fossil and Synthetic Fuels
Committee on Energy and Commerce
House of Representatives
Washington, D.C. 20515

Re: Hearing on the Sales of
Naval Petroleum Reserve Oil
- June 11, 1986

Dear Congressman Sharp:

Champlin Petroleum Company (Champlin) is pleased to tender the enclosed document as a submission to be incorporated into the official record of the captioned proceeding.

Within the paper Champlin addresses the most recent sale auction for Elk Hills crude oil and attempts to clarify some apparent confusion and misconceptions surrounding the DOE's current sale procedure. It is trusted that once the facts and circumstances are known relative to the immediate situation, the need for a legislative remedy and/or for the DOE to abrogate current crude oil contracts will have been obviated.

It is believed that the necessary corrections to DOE's sale auction system can be adequately implemented on the administrative level within the Agency itself, and to that end the company has submitted to the DOE a letter outlining what is considered to be an appropriate adjustment to the current process.

Finally, Champlin would state that, in its opinion, neither the DOE nor the crude oil bidders should be criticized unduly for the present state of affairs. Rather, the offending circumstances appear to be found in the world crude oil market and the most extraordinary volatility witnessed in many years in such markets.

Sincerely,

DW Niemiec

D. W. Niemiec
General Manager, Raw
Material Supply

DWN:ssl
Enclosure

Champlin Petroleum Company
P.O. Box 7
Fort Worth, Texas 76101-0007
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Views Of Champlin Petroleum Company On Sales Of Naval Petroleum Reserve (NPR-1), Elk Hills, Crude Oil

Introductory

Commencing this past May, the Department of Energy (DOE) has encountered criticism from various quarters concerning the management, production, and sales of crude oil from the Naval Petroleum Reserve No. 1 (NPR-1), Elk Hills, located near Bakersfield, California. The prime objection centered around the prices being charged for crude oil during the period April 1 through September 30. Other complaints were aimed at the rate of production of crude oil from NPR-1; the fact that any reserves were being sold from the NPR-1 at all (citing national security risks); the current auction/sale procedures; and whether the NPR-1 was being produced at the maximum efficient rate (MER) of production, as required by law, or at a rate exceeding the MER which could ultimately diminish the recoverable reserves of crude oil available for sale or use. Champlin Petroleum Company (Champlin) believes that much of the criticism against the DOE is unjustified for the reasons detailed below. Unfortunately, the press accounts of this story have been too long on allegations and too short on analysis and facts.

Company Background

Champlin is an integrated petroleum company participating in all phases of the domestic crude oil and natural gas industries with the exception of retail refined product marketing. Specifically within the State of California, Champlin participates in ownership and operation of

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certain sectors of the Wilmington Field (Long Beach area) and owns and operates a 60,000 BPD refinery located in Wilmington. Champlin's equity production from the Wilmington Field is not sufficient to provide the Wilmington refinery's total crude feedstock slate requirement; however, all of Champlin's equity production is dedicated to that refining facility. To supplement its insufficient crude oil feedstock supply, Champlin has from time to time successfully bid on crude oil from the Naval Petroleum Reserve No. 1 (NPR-1), Elk Hills, near Bakersfield. At present the company has a six-month contract for Elk Hills crude oil.

Abrogation of
Current Contracts

As an appropriate remedy, the suggestion has been made to DOE that the current sales contracts (awarded for the period April 1, 1986, through September 30, 1986) should be abrogated and another bidding auction for the remaining supplies available during the rest of the sales period be initiated. Lacking evidence of malfeasance by any government official or any of the bidder-participants, there is no justifiable reason for totally ignoring the doctrine of contract sanctity by now nullifying these agreements. Champlin, and other potential bidders quite likely, would be more than just a little hesitant in attempting to purchase NPR-1 crude oil from the federal government in the future. Reliability of feedstock sources of supply is one of the principal characteristics which a refiner seeks in selecting possible providers of supply. As it is currently, the contract required between the purchasers and the DOE as seller is weighted entirely in the favor of the federal government. Normal non-government contracts do not reflect such a bias whatever. Finally, a further result of nullification of existing contracts would, it could be expected,

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precipitate extensive and costly litigation. Considering all of the facts and circumstances addressed in this paper, the DOE should not entertain the thought of breaking the current contracts.

Understanding The Auction System

Those who would charge the DOE with conducting an inappropriate sale perhaps do not understand the function and economics of the auction-type sale system. In the first instance, the DOE utilizes the auction approach to determine to whom the available crude oil supply will be allocated. Lacking the auction method, DOE would have to draw lots to ascertain who would be entitled to a share of the supply; but then how would a price be established if bids were not made? In such an instance, it would be imperative for DOE to announce a price at which value (for those whose names would be drawn out of a hat) the crude oil could then be purchased. As is apparent, such a lottery methodology would entail considerable shortcomings and would not guarantee the DOE that production would be sold at a satisfactory price. For example, were the DOE to announce a price perceived to be excessive over the delivery period, then it is likely that no bids would be received and the crude oil would not be sold.

The other purpose an auction method serves is the extension of the possibility of premium prices to the seller, i.e., some amount greater than could be obtained under current market conditions. However, along with the prospect of premium prices, the other side of the coin is that there is also always the possibility that an auction will yield below-market proceeds to the seller. The outcome is dependent of course on the bidder's perception of the marketplace over the prospective term of the contract delivery period. Where a bidder is looking eight or nine months into the

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future and recent price trends are downward, then a prudent bid would be at a level less than the going market value to protect the bidder should prices continue the trend and fall further.

In short, an auction system entails gambling on the future in the case of Elk Hills crude oil. The contract delivery period could be shortened to minimize the downside risk to the DOE, but it should likewise be noted that the potential for upside gain and premium prices will also be minimized by such action.

DOE's most recent auction (January, 1986) demonstrates a situation (as described above) where obvious benefits fell in favor of the bidders. On other occasions the benefits have favored the DOE. In any Elk Hills auction, both buyers and sellers must share some amount of market risk.

Continuing Elk Hills Production At The Maximum Efficient Rate Is In The Public Interest

In addition to the present statutory requirement to produce crude oil at the maximum efficient rate of production (MER) consistent with sound engineering, etc., there are further valid justifications as well.

Local Economic Impact - The U.S. General Accounting Office on July 30, 1984, published a report entitled "Naval Petroleum Reserve No. 1 - An Assessment of Production Alternatives" (GAO/RCED-84-180). The GAO pointed out in that report that a shut-in of NPR-1 would cause major problems for small refiners and pipeline companies that rely on NPR-1 production. In addition, the report indicates ". . . it would cause additional unemployment in an area where unemployment in refining and crude oil production is already increasing."

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As to refining, the report noted that the most adverse impact would be to the small refiners whose facilities are located in the Bakersfield--San Joaquin Valley and are dependent upon the NPR-1 light crude oil--there being only nominal similar quality crude oil available in the area. A lack of incoming pipelines precludes these refiners from utilizing imported or Alaskan crude oil. Further, some of the refineries would require extensive and costly equipment upgrading to be able to run heavy crude oils.

Other refiners which would be hurt are those located in coastal areas. The alternative crudes for these facilities would likely be foreign or Alaskan. The foreign alternative is not feasible to a smaller refiner due to the size of a foreign shipment (350,000 - 500,000 Bbls.), the storage requirements, and the lack of financial capability. Alaskan crude oil would not be suitable for refineries designed to run sweet, light crude oil.

The GAO indicated pipelines transporting crude oil from the area would realize a 57 percent drop in throughput. It was also noted that a loss of light crude oil would mean a reduction in the amount of heavy crude oil that could be transported out of the valley. This is because the NPR-1 crude oil is used as a pipeline blender, which facilitates the movement of heavy crude oil through unheated pipelines.

The direct impact of a shut-in upon local employment was estimated at 800 jobs being terminated. It is believed that the ripple effect of these lay-offs upon related and support industries and upon the local economy would result in an ultimate adverse impact upon thousands of employees, not just upon the initial 800 estimated by GAO.

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National Security Concerns - In a situation involving a military and/or defense emergency, the GAO placed little value in a shut-in NPR-1 owing to the extensive time frame required to bring the field into full production from a shut-in mode. Additionally, the authorities of the Defense Production Act were believed to be more than adequate to allow the federal government to obtain all the crude oil feedstocks which might be necessary in a non-peacetime emergency.

Imports Of Crude Oil And Products - To the extent that domestic barrels of crude oil would not be produced by an NPR-1 shut-in, such barrels would be replaced by increased imports of crude oil and/or refined products. The federal government would be hurt in two ways, i.e., the loss of significant revenues in the first instance; and secondly, by the increase in the U.S. trade deficit vis-a-vis the U.S. balance of trade with exporting countries. The bottom-line net effect to the U.S. amounts to the willing exportation of U.S. dollars, jobs, and refining capacity.

The Economic Environment
Encompassing The January, 1986,
NPR-1 Sale Auction

Several charges leveled at the DOE in connection with deliveries under the current contract period (April - September) can be demonstrated to be invalid by a consideration of the facts in each situation. Two graphs are appended herewith which will be referred to from time to time. Graph A is a representation of Elk Hills average high postings (used for base price purposes for the NPR-1 auction) compared to West Texas Intermediate (WTI) prices for the month of January, 1986. Graph B presents the same prices but for a greater period of time, i.e., October, 1985, through and

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including March 31, 1986. WTI crude prices are relied upon regularly to reflect world market conditions. Therefore the graphs accurately depict the relationship between Elk Hills average high prices and the going market value of WTI crude oil.

Question: If Elk Hills crude prices are currently out of line, why and how did they get that way?

Response: The prices of NPR-1 crude oil (subject to the DOE sales auction) for the period April 1, 1986, through September 30, 1986, were determined by bids placed on or before January 27, 1986. Bids consist of a premium or a discount from a reference base price consisting of the average of the 3 highest postings in the area. Subsequently, as postings may change, the reference base price to the purchaser will likewise change but the add-on for a premium or the deduction for a discount will remain constant over the term of a contract.

On January 27, the average of the 3 highest postings for Elk Hills was a little less than $25.00 per barrel. Graph B reflects that this price had remained unchanged from October 7, 1985, through January 31, 1986, even though WTI (and world) prices had dropped $10.00 (roughly by one third) a barrel during the same time frame. Bidders then were faced with the situation reflected on Graph A, i.e., market prices for spot crude oil had fallen precipitously during January to less than $19.50 a barrel at bidding time. Nonetheless, the average high postings remained unchanged at the near $25.00-per-barrel mark, a difference of $5.00 to $6.00 per barrel. Therefore, a bidder who believed the market had bottomed out, and in light of the non-movement of the postings for the field, would have bid a minimum

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discount in the range of the indicated spread between market prices and postings--or $5.00 to $6.00 per barrel. The majority of prospective purchasers did in fact bid at least a $5.00-per-barrel or higher discount which they would have had to do to protect their best interest in light of the postings remaining firm.

Thus the discounts referred to in the press and elsewhere appear excessive until the pricing environment on January 27, 1986, is fully understood. As it happened, postings did begin to fall prior to April - September deliveries and consequently the reference base price fell as well. However, it will be noted on Graph B that the average high postings still consistently exceeded spot prices anywhere from $2.00 to $5.00 per barrel. The convention of using the 3 highest postings in the field tends to distort a common perception of posted prices equating to market value prices with an upward bias upon the former. Some posters traditionally post high while some posters traditionally post low in relation to current market values. Posting philosophy is unique to each company, and it is unknown why particular posters post as they do.

Taking the above factors into account makes clear the fact that when prospective purchasers bid for April-through-September deliveries, their bids were not out of line whatever with the facts and circumstances existing at the time. Prices subsequently paid by the purchasers are determined by the postings and the reference base price and are entirely out of control of the successful bidders. Depending upon market movement, purchasers are as likely to be hurt as helped by subsequent price fluctuations. The same is true for the DOE. Nonetheless, the prices, when determined by bid initially, were not out of line from the bidders' perspective.

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An Allegation: When DOE announced the winning bids for April - September, 1986 deliveries, the announcement "broke" local crude markets and sent spot prices sharply lower.

The Response: As Graph B illustrates, spot market prices began declining toward the end of November, 1985, and with minor interruption continued steadily downward through March 31, 1986, the last date portrayed on the graph. Subsequent to the February announcement of winning bids, the postings of Elk Hills producers began to reflect the reality of the price decline which started in late November, 1985, and which exhibited impressive signs of continuing downward. To therefore conclude the DOE announcement "broke the market and sent spot prices sharply lower" constitutes an unfounded and unsupportable conclusion. The fact is that Alaskan North Slope crude is by volume a much greater factor in California crude pricing than is the volume from Elk Hills. However, the Alaskan crude oils fell proportionally to WTI prices during the period--demonstrating the pervasive nature and impact of world prices and markets.

Champlin Petroleum Company
Fort Worth, Texas
June 24, 1986

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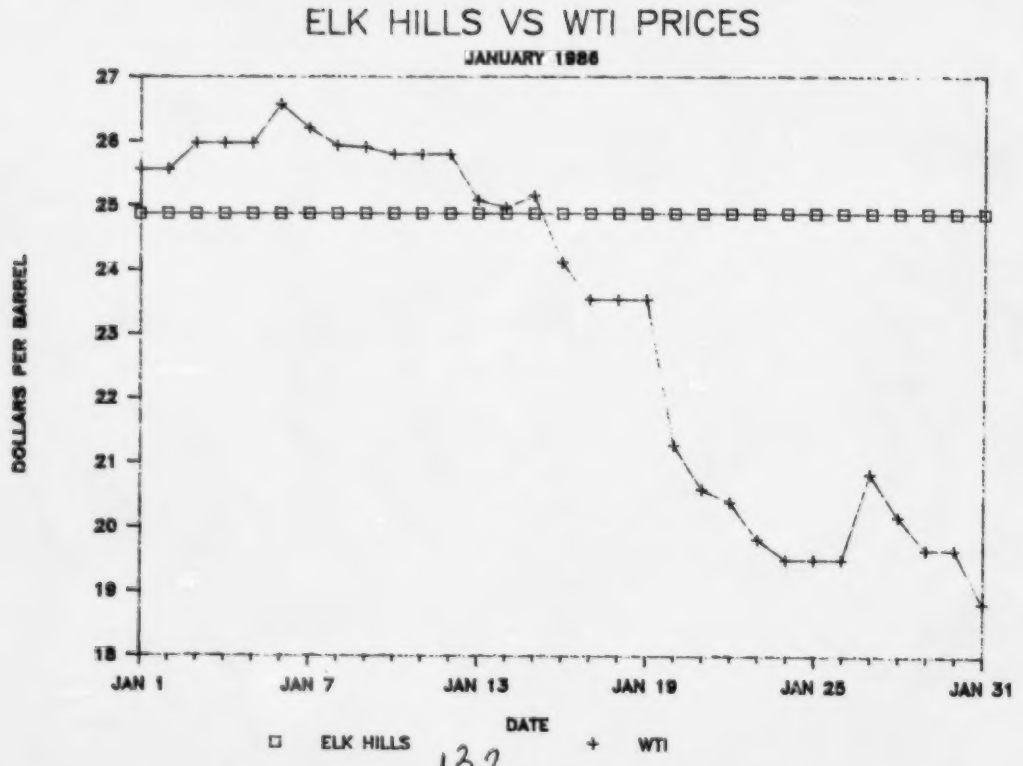
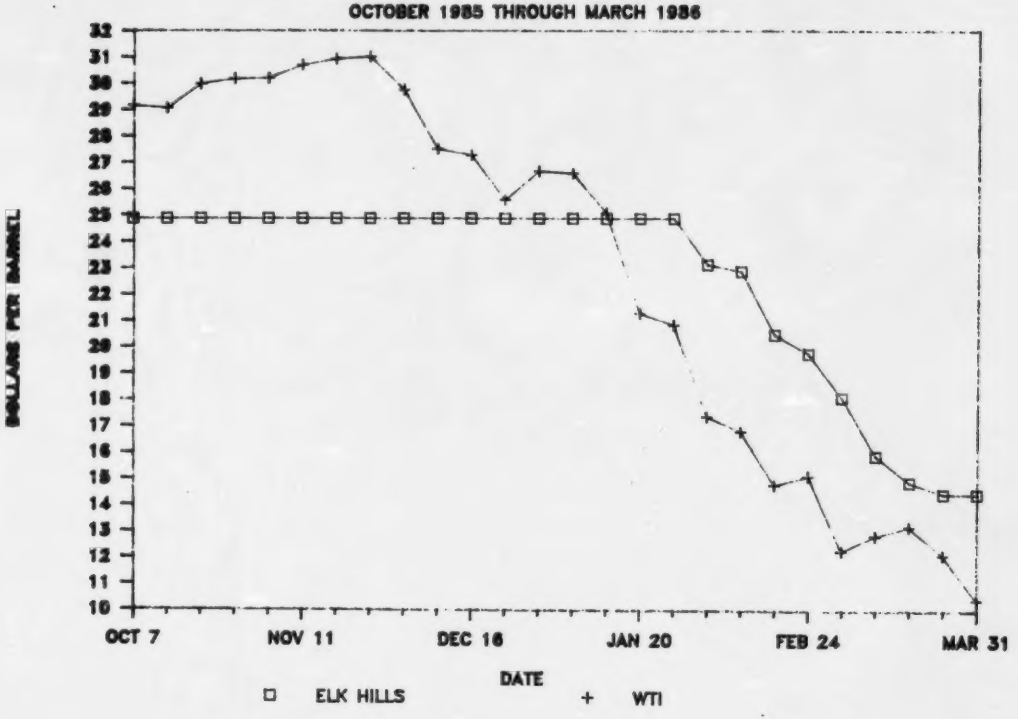


ELK HILLS VS WTI PRICES



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Kern Oil & Refining Co.
ROUTE 6 - BOX 336
BAKERSFIELD, CALIFORNIA 93307
(805) 845-0761

June 19, 1986

Hon. Philip R. Sharp
Chairman, Subcommittee on Fossil and Synthetic Fuels
Committee on Energy and Commerce
U. S. House of Representatives
Room H2-331, House Annex No. 2
Washington, D. C. 20515

Re: Sale of Naval Petroleum Reserve Oil

Dear Mr. Chairman:

Kern Oil & Refining Co. ("Kern") welcomes the opportunity to provide comments regarding the procedures for production and sale of crude oil from Naval Petroleum Reserve No. 1 ("Elk Hills"). Kern is a small, independent refiner with a crude oil capacity of 21,400 barrels per day. Kern's refinery is located approximately 30 miles from Elk Hills in Bakersfield, California.

Kern's refinery is designed to process primarily light, sweet crude oil of the quality of Elk Hills oil. Kern is able to process a maximum of 6,000 to 8,000 barrels per day of the heavy crude oil that predominates California production if Kern is able to obtain sufficient quantities of light crude oil to blend with the heavy oil. Prior to 1980, Kern did not purchase Elk Hills oil in substantial quantities because it had historic supplies of light crude oil whose availability was protected by the "Supplier/Purchaser Freeze Rule" of the Mandatory Petroleum Allocation Regulations, 10 CFR Section 211.63*. Since 1980 when it lost its previous major supply of light crude oil, Kern has been an aggressive bidder at each Elk Hills oil sale, and has supplied up to 60 percent of its refinery needs by direct purchases of Elk Hills oil from the government. Kern purchases additional quantities of Elk Hills oil from other successful bidders when it is available.

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* Kern's right under Section 211.63 to its historic supply of crude oil during the 1979-80 period is still being litigated in the United States District Court for the Central District of California, Kern Oil & Refining Co. v. Tenneco Oil Company, Case No. 81-3253.

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If Elk Hills oil becomes unavailable, Kern has no alternative supply of suitable crude oil and will be forced to shut down. Kern is under contract to the Department of Defense to supply some 32 million gallons of jet fuel annually to West Coast military bases. The jet fuel contracts, like the Elk Hills crude oil contracts, were awarded on the basis of competitive bids. Should Kern be unable to perform its jet fuel contracts due to the crude oil being unavailable, the Department of Defense will lose the benefit of its contracts with Kern and most likely will have to pay more than its contract price with Kern to replace the jet fuel.

Pursuant to the Naval Petroleum Reserves Production Act of 1976, Elk Hills oil is sold to the highest qualified bidder in free and open competition. The government has realized enormous profits by selling its Elk Hills oil in this manner. According to the written testimony of DOE Acting Assistant Secretary Donald L. Bauer, submitted to this Subcommittee on June 11, 1986, from 1980 through March 1986 the government obtained nearly $290 million in bonuses over the posted prices for its Elk Hills oil.

It is by now abundantly documented that the posted prices and the market price for crude oil in California were thrown out of sync in January of this year by the rapid decline in world oil prices. As a consequence, DOE received lower prices for its crude oil than it would have received had the sale taken place a month earlier when posted prices and market prices were in closer proximity. The government cannot expect to be totally exempt from the vagaries of the marketplace however. It is unrealistic to expect the government to be able to collect large bonuses during years of tight supply and then somehow suspend the operation of those same market forces when demand is momentarily soft.

All of the witnesses at the June 11 hearing recognized the extreme importance of devising an improved Elk Hills bidding procedure. Kern has submitted comments to DOE in that regard, as have other historic bidders and interested parties. DOE has committed itself to revising the bidding procedure in time for the next bid solicitation. Kern believes that it would be inappropriate for Congress to tie DOE's hands by legislating changes in the bidding procedure before DOE's revised procedures have been given a chance to work.

Imposing a minimum price on Elk Hills oil related to the posted price of similar crude oils in the area is unwise because the posted prices do not necessarily reflect the true value of the crude oil, or what a refiner is able to pay for the oil. Kern and other refiners are only able to bid prices for crude oil that are supported by local product prices. A refiner cannot possibly afford to pay posted prices for its crude oil if the value of the products that can be manufactured from that crude oil is lower than the crude oil's posted price, as was the case in January of this year.

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It is ironic that the California Independent Producers Association ("CIPA") advocates shutting in Elk Hills if the oil cannot be sold at market prices, since shutting in Elk Hills would have a devastating effect on heavy crude oil producers as well as independent refiners. Shutting in Elk Hills would hurt heavy crude oil producers in three ways. First, if Kern and other San Joaquin Valley independent refiners were forced to close their doors due to lack of light crude oil, the market for heavy crude oil would be severely reduced. Second, if Elk Hills oil were not available as a pipeline diluent, the heavy crude oil that cannot be refined in the Valley would have to be trucked to refineries near Los Angeles or San Francisco at a much higher cost than would be the case if it could be blended with Elk Hills oil and delivered by pipeline. Third, if Elk Hills were shut in, much of the Elk Hills gas production that is required for heavy oil production by steam injection would be unavailable.

Kern believes that the recent DOE action reducing the amount of Elk Hills oil produced and sold was ill-advised. To set the record straight, the reduction from the contract volumes was approximately 22 percent rather than 17 percent as announced. Kern has not reviewed the documentation used by the DOE's Inspector General to support the recommended reduction, but acknowledges Chevron USA's superior expertise on the matter of reservoir management. Chevron, as a 22 percent owner of the field, has no interest in over-producing the field and losing ultimate recovery. Chevron's testimony before the Subcommittee indicates that the whole issue of production in excess of the Maximum Efficient Rate is a smokescreen to allow the DOE to renege on its contracts with Kern and the other successful bidders in the January sale.

Finally, Kern is totally opposed to any attempt on DOE's part to cancel the existing Elk Hills contracts prior to the October 1, 1986 end of their term. Kern's views on that issue are contained in a letter to Mr. Bauer dated June 12, 1986, a copy of which was forwarded to the Subcommittee. We request that our letter to Mr. Bauer be made a part of the record of this proceeding.

Yours very truly,

Thomas L. Eveland
Vice President - Government Affairs

TLE/lbt

cc: Hon. William M. Thomas

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E. J. Barnes
President

NEWHALL REFINING CO., INC.

June 10, 1986

The Honorable Phillip R. Sharp
U. S. House of Representatives
Washington, D.C. 20575

Dear Congressman Sharp:

In response to the Energy Fossil Fuel Subcommittee notice of its hearing on Wednesday, June 11th, Newhall Refining Co., Inc. respectfully submits the following comments relative to the Elk Hills situation and your proposed legislation, H.R. 4843.

Newhall Refining Co., Inc. has operated as a small, independent refiner in South Central California for over 35 years. For over 20 years, Newhall has been a reliable and competitive supplier of jet fuel and other petroleum products to various U. S. military bases in California, Alaska and Hawaii.

Newhall Refining Co., Inc. finished retrofitting the refinery five years ago (March, 1981) at a cost of approximately 34 million dollars, which is still being paid off. The refinery was upgraded from a small heavy oil refinery of 8,500 BPD (16 gravity) to a 21,400 BPD (28 gravity) light oil refinery based on light crude from the San Joaquin Valley via Lines 1 and 63. In addition to two new crude units, a reformer, desulfurizer unit and other off-site facilities were constructed in order to make unleaded gasoline, low sulfur distillate fuel oil, low sulfur fuel oil for the Utilities, jet fuels for the military, as well as asphalt, and some high sulfur residual fuel oil, when economics justify.

Newhall is strategically located next to Four Corners' two south bound crude oil pipelines (Lines 1 and 63) from the San Joaquin Valley to Los Angeles. Elk Hills, which is connected to these pipelines, is our primary and only source of economic light (30+ degree) crude oil. In April, Newhall's crude runs were 21,400 BPD of which 98% was Lines 1 and 63. Prior to April we were running over 18,000 BPD. Without Elk Hills, the quality of the oil in that pipeline could be reduced to a heavy gravity crude oil, (perhaps as low as 18 degrees API) with a substantial reduction in rate. At this crude quality, Newhall would not be a competitive supplier of military jet fuel and other refined products. Also, our crude rate, as defined by our asphalt market limitations, could be less than 11,000 BPD which could force us to shut down the reformer, the desulfurizer and one crude unit. In this we operating mode, we would be eliminated from the finished product markets for gasoline, low sulfur diesel, commercial jet fuel and reduce our military jet

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fuel over 70%. This pre-retrofit topping configuration is not economically viable for the Company which could force us to shut down and close our doors. Therefore, crude oil from the Elk Hills reserve (directly or indirectly through other purchases and exchanges) is a vital source of light crude oil to Newhall.

Elk Hills is the largest light oil reserve available to independent refiners in the State. In the absence of Elk Hills production, very little light crude (perhaps only 20,000 BPD from independent producers -- as most of its controlled by the majors) would be available for Newhall and other Valley light oil refiners, which might also be forced to shut down or drastically curtail their operations. This 20,000 BPD would need to be shared among Newhall and currently operating Valley refineries with a total light oil capacity of 72,000 BPD.

The separate proposal to redirect Elk Hills production to Texas via All American Pipeline and/or exporting (which is presently prohibited by law) would have the same adverse supply impact as shutting it in.

Relative to the unusual, turbulent, traumatic, world-wide crude oil free-fall conditions, the January 27th bid date was unfortunately the worse point in time for bidding on the current period. As shown in Schedule A, as well as the AIRA graph (Schedule B), the spot crude market fell $7.00 barrel in less than three days, five days before the bid date. If the bid had occurred two weeks before or two weeks after there would not have been such a bidding aberration. Regrettably, this first time (hopefully one time) situation occurred. At current price levels, it does not appear that such an aberration could occur again on the down side but one could occur again on the upside.

Since over 75% of world oil is under foreign governments' control, it appears impossible to come up with a fool proof pricing mechanism, but we will certainly try to work with your committee and the DOE to update the mechanism to be more flexible and responsive. As you may know, since February 1980 and up until last year, Elk Hills was sold at premiums, (in February 1980 as high as $11.12 per barrel, with the weighted average of approximately $7.00 per barrel more than 150 million dollars in bonuses were generated). The total estimated bonuses from February 1980 to April, 1986 have been over 260 million dollars, as opposed to the 55 million dollars estimated loss versus postings for the current contract. However, Newhall realizes that the historical average does not necessarily alleviate the current situation. Hopefully, with some understanding and comprehension we will mutually learn to deal with future Elk Hills bids. For the first time since decontrol (after four years of reductions in refining capacity and small refiners going out of business), we refiners inadvertently benefited from the most recent turbulent market. This should be contrasted to the millions we lost in the first quarter of this year on the prior Elk Hills contract during the free fall. Although we don't expect to have this happen again, that is why we are working with all concerned to preclude this possibility in the future.

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In the DOE May 30, 1986 proposal containing the five alternative sales methods, Newhall favors Alternative E. Our analysis of the current pricing method and alternatives A, B, C and E is presented in Schedule C. Had any of the alternatives been in place for the current contract period and the previous two contract periods, the prices paid and received under Alternative E come closest to prevailing market prices and would have prevented the current unusual discounts. Alternative E clearly offers the most improvement to the provisions under which DOE sells crude oil from NPR-1. Furthermore, its floor feature is also consistent with your recently proposed Elk Hills legislation, H.R. 4843.

Newhall feels that Alternatives A and D are undesirable for a variety of reasons:

- Alternative A is not in the government's best interest in as much as the market could rise such as it did last fall and then the government would be receiving less than market price.

- Alternate D, the market basket approach, is undesirable for several reasons. First, it computes the price of Elk Hills according to product prices when the real alternative for the buyer and the seller is the prevailing market price for other crude oils. Secondly, the market basket approach uses non-market related San Francisco fuel oil prices (38 cents/gallon). Most Elk Hills crude is refined in Central and Southern California. The fuel oil is sold in the Los Angeles basin at substantially lower prices than the San Francisco market. The current Los Angeles Bunker Wire price is $8.12/barrel (19 cents/gallon).

Furthermore, the product slate is heavily weighted towards gasoline, far more than the average Elk Hills refiner customer can make.

Newhall Refining Co., Inc. in general supports the AIRA recommendations on the pricing mechanism and the proposed contractual changes:

1. Favor reducing the time between the Invitation For Bid publication and the bid opening date to 15 days.

2. Favor retaining the Notice of Awards prior to the tenth day of the month before the month of first delivery.

3. Favor opening the bids on Thursday after 3:00 p.m. Eastern Time.

4. Favor retaining incremental bidding and the statutory prohibition on exports.

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5. Strongly urge retaining statutory 20% allowable maximum purchased by successful bidder.

6. Favor automatically adjusting the security requirement when the security provided is 10% more or less than the last preceding security.

7. Strongly favor adding at least 30 days notice prior to any action taken to significantly change production.

Newhall Refining Co., Inc. certainly supports the government updating the pricing mechanism to mitigate downside pricing effects and changing other facets for the expeditious sale of Elk Hills oil. Newhall appreciates the opportunity to comment on this most important and complex issue confronting the small independent refiners such as Newhall. We regret that we do not have more time to analyze the previous and current situation in more depth.

If any further information is desired please advise. We will be more than happy to oblige.

Respectfully,

NEWHALL REFINING CO., INC.

E. J. Barnes
President

EJB/dlc

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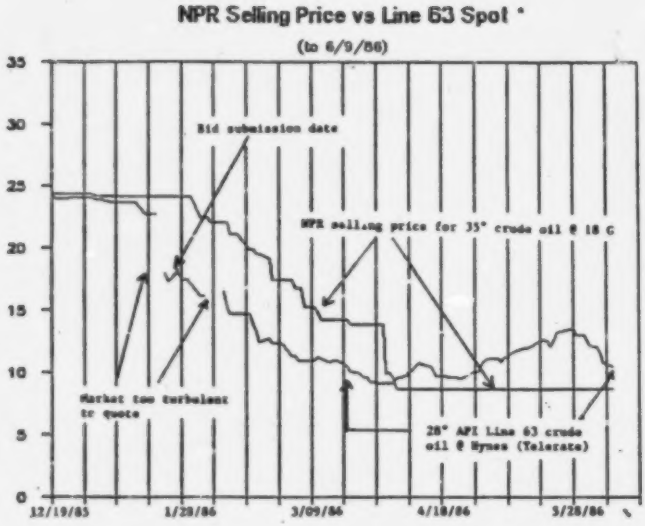
SCHEDULE A



The above NPR Selling Price versus Line 63 at Hynes shows that purchasors paid as much as 7.09 $/B over Line 63 in the First Quarter of 1986 during the free-fall of world crude oil prices. Currently, the difference between Line 63 and the NPR Selling Price is decreasing as all major petroleum product prices drop on the West and Gulf Coasts. Based on historical West Coast product pricing, this narrowing should continue through the contract period.

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*To equate 28° API gravity Line 63 quotes at Hynes to 35° API crude at 18G, one must add Four Corners gravity differential and subtract the line tariff and line loss. This total differential has ranged from 51¢/barrel to 90¢/barrel since Tolerate began quoting on November 9, 1984.

WMB/dlc
6/10/86

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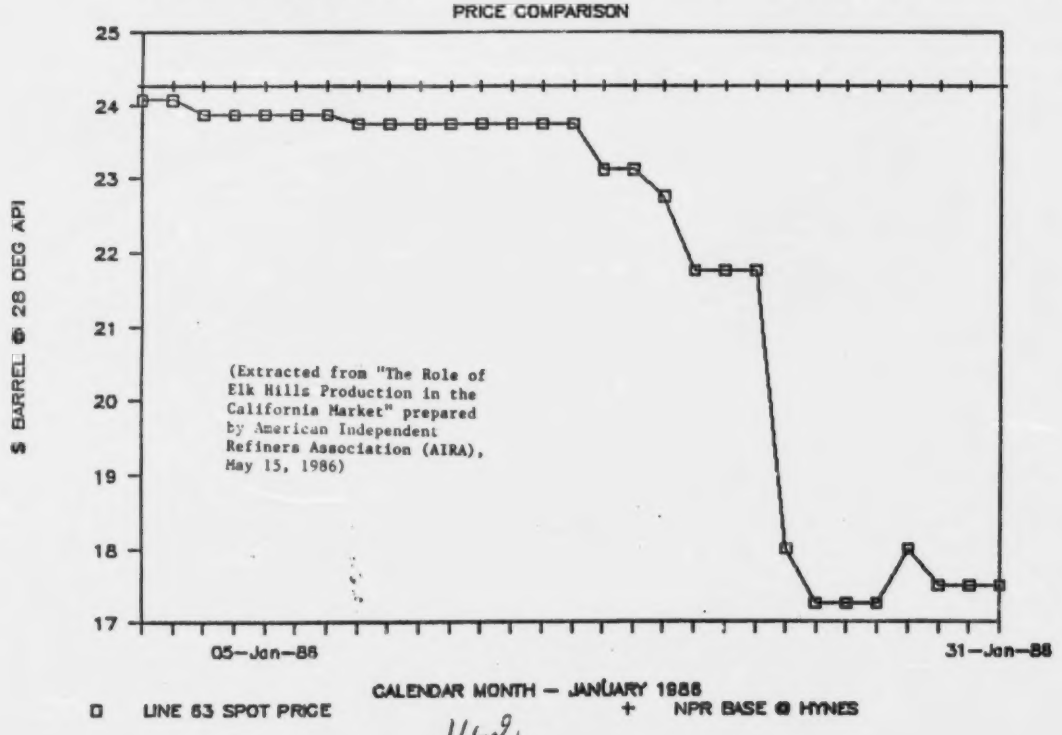
ELK HILLS CONTRACT VS. LINE 63 SPOT



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SCHEDULE B

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Schedule C

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DOE Selling Price
Vs.
Prevailing Market Prices

Average Dollar per Barrel Difference
(DOE Selling Price Less Prevailing Market Price)

Contract Period	Case A	Case B	Case C	Case E	Actual
April 1985 to October 1985	$0.37	($0.06)	($0.06)	($0.12)	$0.43
October 1985 to April 1986	$4.43	$0.43	$0.52	$0.57	$2.23
Current Contract to June 1986	$4.74	($2.13)	($4.46)	($1.58)	($2.19)

Shorthand Formula Definitions

Case	Term	Bid	Formula	Floor
A	60 Days	Fixed Price	Bid	None
B	6 Months	Fixed Price	Bid x (CRP / BRP)	None
C	6 Months	Fixed Price	Bid + (CRP - BRP)	None
E	6 Months	+/- Adjustment	BRP + Bid + (RAP - BRP)	90% of RAP
Actual	6 Months	+/- Adjustment	POSTING + Bid	None

Definition of Terms

BRP	is the rolling average Telerate and Reuters mid-points for 20 working days prior to 65 days before first delivery date. (Fixed for duration of the contract)
CRP	is the average of Telerate and Reuters mid-points for the month of deliveries.
RAP	is the 20 working day rolling average Telerate and Reuters mid-points for the working days during the month of delivery
POSTING	is the average of the highest three postings for five crude oil fields.

Since Telerate data was available from 11/09/84, their daily average was used as the Prevailing Market Price and not the average of Telerate and Reuters.

Please advise if you require any clarification or additional information concerning this schedule.

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E. J. Barnes
President

NEWHALL REFINING CO., INC.

June 18, 1986

White Paper on Elk Hills Purchasers' Gains/(Losses) versus Prevailing Market

As acknowledged by the Department of Energy, et. al., purchasers of Elk Hills crude lost substantial money in the first quarter of 1986 and are slowly recouping it through the second and third quarters. This White Paper summarizes those gains/(losses).

The Department of Energy's actual sales price was compared to the prevailing market price (as reported by Telerate Systems, Inc.) for a crude oil widely sold at a common carrier terminal in Southern California (Four Corners Pipeline Company's Hynes Station). The prevailing market price of this crude oil, known as Line 63, was adjusted in value to equal the quality of Elk Hills crude oil at the point of sale. The difference between the DOE's actual sales price and the prevailing market price (on a comparable basis to Elk Hills crude) was multiplied by the actual barrels sold and the remaining barrels planned at the lower production rate. These very detailed calculations are the only way to fairly represent what actually happened or will likely happen to both the purchasers' and the seller.

In the first quarter 1986, buyer's suffered a combined loss of $26,960,000. Through the second quarter, buyers will have recouped $17,880,000 and, assuming no change in current crude market conditions, will break-even in early September.

	Purchaser's Gain/(Loss)* $ By Period	Cumulative
Purchasers' first quarter loss	$(26,960,000)	$(26,960,000)
Purchasers' second quarter gain	17,880,000	17,880,000
Purchasers' estimated third quarter gain		
July	4,320,000	22,200,000
August	4,320,000	26,520,000
September	4,180,000	30,700,000
Total estimated gain over entire contract period	30,700,000	

*Difference between Telerate working day mid-point "backed-up" to NPR and DOE Selling price.

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The Line 63 prevailing market price on June 10, 1986, $10.50 per barrel, was used to estimate the remaining third quarter gain. That may be high in view of the current falling product prices.

The critical assumptions used to equalize the prevailing market price for 28 degree Line 63 crude at Hynes to 35 degrees Elk Hills crude at the point of sale (18G) are 1) the Four Corners published pipeline tariff, loss allowance, fill requirement and gravity bank, 2) the money costs associated with the difference in payment terms for Elk Hills and Line 63 crude, and 3) DOE pipeline tariff from the point of sale to Four Corners Pipeline.

For example, on June 10, 1986, the netback adjustment to the prevailing market price of Line 63 crude oil is as follows:

Item	$ Per Barrel
Four Corners Gravity Bank from 28 degree API to 35 degree API	$1.030
Four Corners Pipeline Tariff from 18G LACT to Hynes Station	(.449)
Four Corners Pipeline Loss Allowance, 0.25%	(.030)
Four Corners Pipeline Fill Requirement at 15% of daily shipments for 30 days and 10% cost of money	(.020)
Payment Term Adjustment from 7 days (Elk Hills) to 35 days (Line 63) at 10% cost of money	(.080)
DOE's Pipeline Tariff from DOE's 18G LACT station to Four Corners Pipeline Co.	(.050)
Net Adjustment to Line 63 prevailing market price to equal the quality of Elk Hills crude oil at the point of sale	$0.401

Adjustments will differ daily due to changes in the Four Corners gravity bank and the losses and carrying costs associated with different prevailing Telerate Line 63 oil prices.

I hope this is helpful and clarifies this most critical matter. If any further information is desired, please advise.

Regards,

NEWHALL REFINING CO., INC.

E J Barnes

President

EJB:WHB/dlc

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E. J. Barnes
President

NEWHALL REFINING CO., INC.

June 30, 1986

The Honorable Philip R. Sharp
U. S. House of Representatives
2452 Rayburn
Washington, D. C. 20515

Dear Congressman Sharp:

In response to your Fossil Fuel Committee June 16th hearing, we wish to amplify our concern about the possible cancellation of existing Elk Hills contracts, and clarify some of the confusion concerning prior bids.

Newhall, a small Independent Refiner with a capacity of 21,400 barrels per day, and a historical bidder of Elk Hills crude, and dependent upon some for its Line 1 and 63 crude supply, does not feel the cancellation of the current contract is warranted for several reasons:

1. As you know, in the first five years since Oil Decontrol, many of the Independent Refiners did not survive, and for those of us that have, this is the first time we have had an inadvertent benefit, due to circumstances beyond our control - the traumatic free-fall of world crude prices.

2. As you will note in our attachment, we Elk Hills Purchasers, on the last contract, lost heavily against the market the first quarter this year. This computation shows that those dollars lost will not be regained under the current contract until early September.

3. In addition to our own contract, we had to take additional barrels that further increased our losses due to an Independent Refiner which had a labor strike who Force Majeured their Independent Producers' crude supply contracts the week before the January 27th bid.

4. In the February 1980 Elk Hills contract, wherein Phillips' bid $11.12 premium, they were allowed to cancel on 90 days notice, under the terms of the contract - the same right the Government had. This clause was deleted the year following (February 1981), when bids were submitted prior to Decontrol, and the subsequent crude market ran up after Decontrol, caused large losses to NPR purchasers, (Powerine paid a bonus of $5.67 per barrel), and had to perform for the duration of the contract.

Newhall's only economical crude access is from the San Joaquin Valley via Pipelines 1 and 63 (27 + gravity API).

Some refiners did not perform during this period due to going into bankruptcy. As you may know; an NPR purchaser cannot readily walk away from a crude contract without forfeiting their outstanding Letters of Credit.

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Fortunately, the DOE is revising their method of selling NPR crude. We understand this revision is in the mails today, for comments due July 10, for the Bid on August 7, for a 90-day term, beginning October 1. Such revision is in no small part due to your H.R. 4843, and the Hearings you held on June 16.

We appreciate your interest in the NPR sales production and trust the new provisions will be acceptable for all concern, and more responsive to the marketplace, by eliminating some of the past rigidity. For example, the transparencies of the posted price was really brought to light in April, when Chevron, on a small incremental bid a discount of $3.80 off posting, further showing the posted price is not reflective of today's market.

The ongoing persistence of OPEC to regain control of world oil was never so evident as at their meeting last week, in Yugoslavia, when Kuwait's Foreign Minister, El Sabah said, "I think it isn't necessarily in our interest that the price of $28 a barrel is reached too quickly", and who believes OPEC should keep its oil prices low to drive competitors, such as small U.S. producers, out of business. "We should first get (oil prices) to $17 or $18 and stay there for a year or two before going up again gradually". With such OPEC members taking dead aim on U.S. small producers to force them out of business, so that they can then ratchet up the prices later, when the competition is lessened, obviously, does not auger well for the U.S. Oil Energy situation, let alone enable one to predict the fair market value in such a vitriolic atmosphere.

We refiners, of course, feel for the producers' current plight, similar to that which we have endured the first five years of Decontrol. However, Newhall continues to purchase from various Independent Producers at fair market value, in our local area, for Pipelines 1 and 63.

The attachment utilizes Telerate on Line 63, as a benchmark, inasmuch as an Independent Refiner could not survive paying posting on all of his crude with the bottom dropping out of the residual fuel market, and now gasoline and other light products are rapidly falling further. The asphalt market, which had been Newhall's survival niche, is rapidly declining, following the residual fuel market.

Therefore, we do not see where a cancellation of the current contract is warranted. It is estimated that in the last six years, prior to this contract, the Elk Hills bid returned around $300 million in bonuses to the Government, which still leaves them well ahead, as it should be.

We appreciate your interest in this matter, and hopefully, the foregoing will be of assistance in your ultimate resolution of this matter.

Very truly yours,

NEWHALL REFINING CO., INC.

E. J. Barnes, President

EJB:JS/dlc

Attachment

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Attachment

Elk Hills Contract Purchasers' Possible Gains/(Losses) versus Prevailing Market

As acknowledged by the Department of Energy, et. al., purchasers of Elk Hills crude lost substantial money in the first quarter of 1986 and are recouping it through the second and third quarters. This attachment summarizes those gains/(losses).

The Department of Energy's actual sales prices was compared to the prevailing market price (as reported by Telerate Systems, Inc.) for a crude oil widely sold at a common carrier terminal in Southern California (Four Corners Pipeline Company's Hynes Station). The prevailing market price of this crude oil, known as Line 63, was adjusted in value to equal the quality of Elk Hills crude oil at the point of sale. The difference between the DOE's actual sales price and the prevailing market price (on a comparable basis to Elk Hills crude) was multiplied by the actual barrels sold land the remaining barrels planned at the lower production rate. These very detailed calculations are the only way to fairly represent what actually happened or will likely happen to both the purchasers' and the seller, especially since the published prices were substantially above the market, therefore, do not reflect refinery losses. Posted price purchases would reflect substantial refinery losses in todays market.

In the first quarter 1986, buyer's suffered a combined loss of $26,960,000. Through the second quarter, buyers will have recouped $17,880,000 and, assuming no change in current crude market conditions, will break even in early September.

	Purchaser's Gain/(Loss)* $	
	By Period	Cumulative
Purchasers' first quarter loss	$(26,960,000	$(26,960,000)
Purchasers' second quarter gain	17,880,000	17,880,000
Purchasers' estimated third quarter gain		
July	4,320,000	22,200,000
August	4,320,000	26,520,000
September	4,180,000	30,700,000
Total estimated gain over entire contract period	$30,700,000	

**Difference between Telerate working day mid-point "backed-up" to NPR and DOE Selling price.*

The Line 63 prevailing market price on June 10, 1986, $10.50 per barrel, was used to estimate the remaining third quarter gain. Although the current product market prices are continuing to decrease, it has not substantially reduced the prevailing market price. Although the current product market prices are continuing to decline, it has not significantly reduced the prevailing marekt price.

I hope this is helpful and clarifies this most critical matter. If any further information is desired, please advise.

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Congress of the United States

Washington, D.C. 20515

June 4, 1986

MEMORANDUM

TO: Members - Subcommittee on Fossil and Synthetic Fuels, Committee on Energy and Commerce
- Subcommittee on Investigations, Committee on Armed Services

FROM: Subcommittee Staffs

RE: Hearing on Naval Petroleum Reserve, June 11, 10:00 a.m., Room 2123 RHOB

Enclosures:
(1) Historical Review of Elk Hills
(2) GAO Fact Sheet, Naval Petroleum Reserves, May 1986
(3) Letter to Secretary of Energy concerning Elk Hills
(4) H.R. 4843
(5) H.R. 4859
(6) Witness list

BACKGROUND

Naval Petroleum Reserve #1 at Elk Hills, California, is a government owned oil field which has been produced at "maximum" rate since 1977. It is located near Bakersfield, CA, and is the fourth largest domestic field. Enclosure (1) is a historic review of the Naval Petroleum Reserve.

The government is the majority owner, and Chevron U.S.A. Inc. is a 22% minority owner. Chevron and the government share production, revenues, and expenses in proportion to ownership share. The Department of Energy reported expenses of $111 million and revenues of $1.3 billion in generated from the sale of the government's share of crude oil, natural gas liquids and natural gas in FY85. Daily production of crude oil for FY86 is estimated to average 127,000 barrels per day, of which the government's share would be 99,000 barrels per day. For the period April 1, 1986, through October 1, 1986, the Department had intended to sell 82,000 barrels through a bidding process to the public with the remainder being sold to DOD.

BASIS FOR PRODUCTION AT ELK HILLS

The Naval Petroleum Reserves Production Act governs the production of oil from all three Naval Petroleum Reserves including Elk Hills. This Act specifies that every three years the President must review the need to produce Elk Hills oil and report his findings to Congress. This was last done on October 5, 1984, when the President recommended continued production at Elk Hills for the three year period between April 5, 1985, and April 4, 1988.

1. The Act requires that if the President recommends production (as opposed to minimum production), the production will be at the Maximum Efficient Rate (MER) which will permit economic development and depletion of NPR-1 without decreasing the amount of oil expected to be ultimately recovered. Production rates between MER and minimum are not allowed.

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2. The Act also requires that notwithstanding any other provisions of law, the government's share of oil (excluding DOD use) will be sold at public sale to the highest bidder, with a limitation on the amount any one bidder can purchase and with setasides for small refiners.

MER CONTROVERSY

On April 25, 1986, DOE's Inspector General (IG) reviewed MER and concluded:

> "...for the past seven years (production) has exceeded the MER calculated by the Reserve's own engineers and principal consultants. According to studies prepared by the Department's technical engineers and consultants, between 90 and 130 million barrels of otherwise recoverable oil is at risk of being lost through over production during the life of the Reserve. Based on the average market value of $18 per barrel on March 6, 1986 the value of this oil was between $1.60 billion and $2.30 billion."

DOE rejects this IG assumption and claims that the Reserve was produced at the appropriate rate and no recoverable oil has been lost.

Likewise, Chevron rejects the IG report and has stated:

> "(The IG report) relied heavily on data collected prior to 1983.... The IG report did not consider the recent state-of-the-art computer simulated studies done for several rate sensitive reservoirs in Elk Hills. These studies performed since 1985 have verified that the reservoirs have been produced at the appropriate MER and that no oil has been bypassed.... Historical reports, such as used by the IG, are not valid for calculating a MER of an evolving oil field."

The Subcommittees previously reviewed the MER issue in a hearing on October 3, 1984.

RECENT SALES OF ELK HILLS OIL

The government's share of NPR-1 crude oil production is sold on the open market by competitive bidding. DOE solicits bids from interested parties who, in turn, submit bids showing the quantity of oil to be purchased on a daily basis during the coming six-month contract period. Bidders may submit more than one bid. DOE awards contracts starting with the highest bid until all available oil is contracted for.

The total price paid by purchasers for NPR-1 oil is a combination of a crude oil base price and the contractual bonus or discount amount. The major oil companies operating in the central California area periodically send out to all oil producers a "Crude Oil Price Schedule." These schedules reflect the prices the oil companies are willing to pay for oil of a specified type and quantity and become the "posted" price for that oil. DOE receives these price schedules and computes an average price based on the three highest offerings for oil of quality equal to NPR-1 oil and produced from nearby fields. These average prices, with appropriate adjustments, become DOE's crude oil base price for the period covered by the price schedules.

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Historically the base price has been relatively stable. For example, from October 1, 1985 through January 31, 1986, the base price had fluctuated only between $24.88 and $24.95 per barrel. All bids for that period were at discounts from $0.19 to $1.16 below the base price. Historically the bids have typically been at a premium over the base price.

Oil prices in the spot market began to decline in early 1986, but the posted prices in California lagged this decline and did not reflect this price decrease until early February 1986. When bid proposals for the April 1 to October 1 contract period were submitted to DOE, they were made on the basis of the January posted prices. The large discounts offered reflected the January disparity between posted prices and observed spot market prices.

Although DOE's base prices have changed drastically since the time of the bids, the contracted discounts for the April to October 1986 bid period remain. Consequently, the net prices to the government for this period are far below the market prices.

Fifteen companies were awarded contracts to purchase about 82,000 barrels per day of NPR-1 crude oil. These companies bid discounts from the posted prices ranging from $0.97 to $6.98 per barrel.

As the DOE base price dropped to the $13 per barrel range, the prices for the lowest priced oil sold dropped as low as $6.30 per barrel. At this point DOE was paying $12.60 per barrel of oil delivered to the Strategic Petroleum Reserve.

The GAO has documented the NPR sales prices in a fact sheet (Enclosure 2). While the price paid for oil has recently started to rise because the base price is rising, some bidders are still receiving oil for almost $7.00 less than base price. At the hearing the GAO will to provide the latest data on the oil prices. Enclosure 3 is a letter to the Secretary of Energy advising him of the GAO evidence and raising questions about the sale.

DOE ACTION

On May 22, 1986 the Department announced action to reduce the effect of these problems associated with Elk Hills. Effective June 1, 1986, production of Elk Hills was cut from the 127,000 barrel per day level to 106,000 barrels per day. The Department also announced a total review of the sales procedure. The 106,000 barrel level was determined to be the most conservative MER recommended in any of the DOE or contractor evaluations of MER; statutory restrictions prevent production less than MER.

This reduction in production addresses the IG's concern with production above the MER. However, it does not correct the sale of oil for almost $7.00 less than the base price. DOE is applying the reduced production proportionally to all bidders (except DOD which will continue to receive its 15,000 barrels per day). Oil will still be sold with an almost $7.00 discount, only in lesser amounts.

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PREVIOUS COMMITTEE RECOMMENDATIONS

In 1984 at a previous joint hearing on Elk Hills, members of both Committees recommended that DOE should have greater flexibility in selecting production rates other than MER. Secretary of Defense Weinberger also made a similar recommendation. DOE at that time recommended continued production at MER, and the President adopted DOE's position.

PENDING LEGISLATION

Currently there are two bills pending related to this NPR issue: H.R. 4843, introduced by Congressman Sharp, and H.R. 4859, introduced by Congressman Thomas. (Enclosures 4 and 5)

H.R. 4843 allows the production of the Naval Petroleum Reserves at rates other than MER after considering the effect of this NPR production on national energy policy, including the SPR, and long term government revenues. H.R. 4843 also prohibits the sale of NPR oil at prices less than:

1. 90% of the market price, as determined by the Secretary of Energy, or
2. the price of SPR oil adjusted for transportation from the NPR and quality.

H.R. 4859 gives the Secretary of Energy authority to set rates below MER and requires the Secretary to set a minimum price for NPR oil. The bill also allows the President to exempt NPR oil from export restrictions.

Enclosure 6 is the proposed witness list for the hearing.

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Background on the Naval Petroleum Reserve

Neither the Naval Petroleum Reserve nor scandal associated with it is new.

The establishment of the Reserve began with President Theodore Roosevelt's concern for assuring a secure source of oil supply for the U.S. Navy. The Navy was in the process of converting the fleet from coal to oil propulsion.

In 1907 and 1908 the Great White Fleet (because it had been painted white) completed its 46,000 mile around-the-world cruise to prove that the Navy could shift from Atlantic to Pacific operations. The Achilles heel of the operation was oil availability. Coal, because of the vast Royal Navy coaling network, was available world wide. Oil was not.

Roosevelt's concern, compounded by the experience with the Great White Fleet, led to an Executive Order on September 27, 1909, by President Taft, withdrawing certain oil-bearing public lands from general sale.

On June 25, 1912, at the request of the Secretary of the Navy, the Secretary of the Interior identified 38,073 acres in California which was believed sufficient to ensure a supply of 500 million barrels of oil for the Navy. Accordingly, President Taft issued another Executive Order setting aside these lands as the Elk Hills Naval Petroleum Reserve #1 (NPR #1). NPR #1 was enlarged later in the year by acquisition of a second, adjacent tract subsequently known as Buena Vista NPR #2. On April 30, 1915, President Wilson established a third Reserve, Teapot Dome, Wyoming, as NPR #3.

These Naval Petroleum Reserves were developed and managed by the Department of the Navy until President Harding transferred them to the jurisdiction of the Department of the Interior in 1921. In 1922 Secretary of Interior Albert B. Fall arranged for the lease of the fields to private developers without competitive bidding in exchange for construction of naval oil-storage depots.

In both cases, Fall received large sums of money for helping to arrange the transfer - $100,000 from E. L. Doheny for Elk Hills and $300,000 from Harry Sinclair for Teapot Dome. A public scandal broke in 1924 as a result of Congressional investigations into the large profits Doheny and Sinclair received from their unconventional relationship with Fall. Fall was eventually convicted of receiving a bribe, fined, and sent to prison.

In 1927 the Supreme Court returned the Reserves to the United States. Subsequently the NPRs were removed from the Department of Interior and returned to Navy management. Production was halted except for emergency use during World War II. Currently Navy personnel assigned to the Department of Energy operate the NPRs under the direction of the Secretary of Energy.

In an era of high oil imports and rising prices following the Arab Oil Embargo, the Congress passed the Naval Petroleum Reserves Production Act of 1976, which authorized that NPR #1 be developed to its full economic and production potential and that the field be produced for six years. The Act further specified that the President could subsequently extend production for three-year periods after an investigation to determine the necessity for continued production had been made.

Enclosure 1

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In 1981 and again in 1984 President Reagan determined that the NPR should continue to produce at its Maximum Efficient Rate (MER) for an additional three years. Although some observers, including Secretary of Defense Caspar Weinberger, thought NPR oil should be saved for a period of future high prices or shortages, or that it should be produced at less than maximum rates, revenue considerations prevailed, and the U.S. continued to sell oil from this reserve even though buying it for storage in the Strategic Petroleum Reserve.

The original land which was set aside for the NPR did not cover the entire oil reservoir. The additional land above the reservoir was privately held. Chevron Corp. consolidated this ownership. To improve the operation of the reservoir the U.S. and Chevron jointly operate the oil field and proportionately share the oil, with Chevron receiving 22% and the government 78%.

Production at Elk Hills peaked in 1981 at 181,000 barrels per day and declined to 130,000 in 1985. Production at Buena Vista and Teapot Dome combined is less than 10,000 barrels per day. Revenue for the government's share of NPR production was $1.3 billion in 1985.

The Administration has proposed selling the government's share of the Reserve. Congress has not acted on the proposal but has expressed skepticism about the Department's method of estimating the sale price and about selling when the value of oil is at its lowest in many years.

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COMMITTEE ON ENERGY AND COMMERCE
WASHINGTON, DC 20515

May 12, 1986

The Honorable John S. Herrington
Secretary
Department of Energy
Washington, D.C. 20585

Dear Mr. Secretary:

The General Accounting Office has completed a preliminary investigation (copy enclosed) which documents the sale of Naval Petroleum Reserve oil at prices as low as $6.30 per barrel, prices which constitute giving away a valuable public asset at less than its value. At the same time, oil was being purchased for the Strategic Petroleum Reserve at $12.60 per barrel delivered.

I urge you to find a way to stop this unilateral price war. It appears to be due to a bidding process that establishes sale prices for six-month contracts in reference to posted prices, which have become very volatile. It involves the government in a risky game more suitable to speculators.

The process appears to have been designed for stable oil prices but then left on automatic pilot when the market got turbulent. Shareholders would demand a change if a private company's oil were being sold so cheaply; the taxpayers deserve no less.

Coupled with the Inspector General's recent determination that the Department may be producing oil from the NPR at a rate above the Maximum Efficient Rate (MER) and may therefore be reducing ultimate recovery, this leads to the conclusion that current NPR policy and implementation is shortchanging the taxpayer both today and in the future.

Excess NPR production in a glutted oil market also adds to the current difficulties of oil producing regions of the country.

In 1984, prior to the President's recommendation to continue producing oil from the Reserve at MER, I recommended that the law be changed to allow the President a choice other than maximum or minimum production rates. This would add to national energy and economic security in the future by providing for less rapid depletion of the Reserve, but it would also allow the flexibility to consider and balance market conditions, revenue needs, strategic concerns, domestic producers' interests, and California refiners' needs. The Department of Defense concurred with this recommendation. The Department of Energy disagreed, however, and the President went along with your recommendation to continue maximum production.

Enclosure 2

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In light of the GAO's evidence and the Inspector General's report, please provide your recommendations on how such results can be avoided in the future.

- With both posted and spot prices for California sweet crude far above DOE's lowest sale price, is DOE in violation of the NPR Act of 1976 requiring sales to be "not less than the prevailing local market price of comparable petroleum?"
- How can bidding procedures that may have been appropriate in the past be changed in light of today's rapidly changing oil market?
- Should the law provide you with the flexibility to alter production rates in order to avoid fire-sale prices?
- In the absence of a law giving you flexibility to slow the rate of production, can you avoid selling the oil too cheaply by purchasing it for the SPR?
- Can a floor be established under NPR sales prices, perhaps similar to the one we agreed upon for the SPR test sale?
- With oil prices so low and the oil economy in trouble, do you still believe it makes sense for the U.S. to sell as much oil as possible from the NPR and to cease purchasing oil for the Strategic Petroleum Reserve?

In addition to raising concerns about the Department's stewardship of this valuable national asset, these sales will undoubtedly have an impact on the proposed sale of the entire NPR. I am sure you can understand that Congress and the public are likely to be skeptical about the Department's ability to obtain a fair market price for a multi-billion dollar oil field if it currently undersells its product.

I would appreciate having your explanation and response to my questions by May 23, 1986.

Sincerely,

Philip R. Sharp
Chairman

Enclosure: GAO report

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The Secretary of Energy
Washington, DC 20585

May 29, 1986

Honorable Philip R. Sharp
Chairman, Subcommittee on Fossil
and Synthetic Fuels
Committee on Energy and Commerce
House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

This is in response to your letter of May 12, 1986, which raised concerns regarding the production and sale of crude oil from Naval Petroleum Reserve No. 1 (NPR-1), Elk Hills, California. As I indicated to you in our recent meeting, I had previously initiated reviews of our production and sales procedures because of similar concerns.

As a result of these reviews, I have directed a series of steps to help ensure that oil production from the Reserve reflects sound engineering practices and that the taxpayer receives the full market value of crude oil sold.

Among the actions I have directed is approving the use of the most conservative engineering judgments for establishing the statutorily required "maximum efficient rate" (MER) of production at Elk Hills. The new production rates are within the range of current MER estimates and will result in an immediate cutback of approximately 16 percent in current production from Elk Hills. To ensure that production rates are not excessive, I have ordered an independent engineering evaluation of production rates of two of the field's major reservoirs which account for nearly 60 percent of Elk Hills' total production.

I also have directed a thorough examination of alternative strategies for conducting the next round of Elk Hills oil sales with deliveries beginning this October. Although the current procedure for inviting bids reflected our attempt to encourage the broadest possible participation by potential buyers under existing statutory requirements, it clearly has fallen out of step with today's marketplace.

The changes I have asked to be studied are intended to ensure that we can respond better to changing market conditions. It was the volatility of the marketplace at the time of the most recent bidding, more than anything else, that accounted for the heavily discounted bids. I am committed, however, to put into place the best possible bidding process that continues to encourage broad market participation but which also provides adequate safeguards for the taxpayer.

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We will consider alternative contract durations, bidding procedures and pricing provisions for future contracts. We will discuss revised approaches with market participants in the California area, and any improvements in the process that are required will be made in time for the next contracting period.

The actions I have taken represent those that are possible under my existing statutory authority. As I believe you recognize, there are provisions in current law which limit the Department's flexibility to respond more quickly to the market in selling Naval Petroleum Reserve oil. Examples include a 20 percent limitation on the amount which can be sold to a single person and the limitations on contract durations. I believe we can work together in analyzing these and other statutory provisions so as to ensure that the taxpayers receive full market value for their assets and that we are more aligned with the marketplace in conducting future sales of NPR oil.

As to the specific inquiries of your May 12 letter, I believe we can provide better and more thorough responses after the Department undertakes its internal review and study of these issues. Your concerns highlight several of the specific questions that the Department's review process must address in some detail.

Once again, I appreciate your interest and concern about the production and sale of crude oil from the Naval Petroleum Reserves. I hope that we can work together on this issue in the future as we attempt to develop approaches that offer the most benefit to the American taxpayer.

Yours truly,

John S. Herrington

John S. Herrington

cc: Honorable William E. Dannemeyer
Ranking Minority Member

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